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In the Supreme Court of the United States

OCTOBER TERM, 1996

ERNST & YOUNG LLP, PETITIONER

v.

STANLEY KNAPP, ON BEHALF OF HIMSELF AND ALL OTHERS SIMILARLY SITUATED, ET AL., RESPONDENT

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether a general jury verdict may stand when one of two alternate theories of liability submitted to the jury is legally erroneous.

PARTIES TO THE PROCEEDING

The parties to the proceeding in the court of appeals were Ernst & Young LLP,* Daniel O'Connor, Phillip Gomez, and Stanley Knapp, suing on behalf of himself and all others similarly situated.

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* On October 1, 1989, the accounting firms of Arthur Young & Company and Ernst & Whinney combined to form the firm of Ernst & Young LLP, the petitioner in this case. This suit originally was filed in 1987 against Ernst & Whinney.

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PETITION FOR A WRIT OF CERTIORARI

Ernst & Young LLP respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-20a) is reported at 90 F.3d 1431. The order of the court of appeals denying rehearing (App., *infra*, 68a-69a) is unreported. The opinion of the district court addressing post-trial motions on damages issues and also denying Ernst & Young's motion for a new trial on the question presented in this petition (App., *infra*, 23a-44a) is unreported. The opinion of the district court denying motions for judgment as a matter of law or for a new trial on liability (App., *infra*, 45a-67a) is reported at Fed. Sec. L. Rep. ¶ 97,645.

JURISDICTION

The judgment of the court of appeals was entered on July 23, 1996. See App., *infra*, 2a, 20a. A timely petition for rehearing was denied on September 4, 1996. App., *infra*, 68a-69a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT

This case presents a question that has deeply divided the courts of appeals and that controls the outcome of innumerable federal civil cases: whether a general jury verdict can stand if it is founded in part on an erroneous legal theory. This Court has consistently reversed a general verdict whenever "one theory of liability upon which the general verdict may have rested" is "erroneous." *Sunkist Growers, Inc.* v. *Winckler & Smith Citrus Products Co.*, 370 U.S. 19, 29 (1962). See also, *e.g.*, *City of Columbia* v. *Omni Outdoor Advertising, Inc.*, 499 U.S. 365, 384 (1991); *Maryland* v. *Baldwin*, 112 U.S. 490, 493 (1884).

As one would expect, most of the courts of appeals have followed this Court's directive. The Ninth Circuit, however,

has marched to a different drummer. Disdaining this Court's bright-line rule, the court below instead has held that the decision whether to uphold a general verdict that could rest upon either an invalid or a sound legal theory is "entirely discretionary." App., *infra*, 14a. And some other circuits have engrafted narrower exceptions onto this Court's rule. Because the treatment on appeal of general jury verdicts is of recurring importance, this Court should grant the petition for a writ of certiorari in order to reaffirm its precedent, to correct the Ninth Circuit's impermissible deviation from that precedent, and to resolve the disagreement among the circuits.

A. Factual Background

The factual setting of this case is familiar: a patently risky enterprise issues stock to the public, the business goes poorly, the stock price falls, and the stockholders bring suit. Philip Gomez, Douglas O'Connor and Frank Gleason formed ATV Systems ("ATV") in May 1981 as a venture specializing in "turnarounds" of bankrupt high technology companies. App., *infra*, 2a-3a. The three founders were experienced both in high-tech industries and in turnarounds, having restructured other troubled businesses into profitable enterprises. *Id.*

ATV's business plan was to buy troubled companies, liquidate unprofitable product lines, and merge the profitable lines with its operations. App., *infra*, 2a-3a. ATV's prospects for success depended on its ability to incorporate the advantages of the failing companies (usually intellectual property or technological know-how) and jettison their flawed elements (often structural or management-related) before those flaws and the resulting losses dragged the parent company under. *Id.* at 46a.

ATV soon outgrew its original financing. In October 1982, it sold $10 million in convertible debentures to venture capital groups, and soon thereafter began preparing for an

initial public offering ("IPO") of its stock. ATV engaged petitioner Ernst & Young to act as outside auditor for the IPO. App., *infra*, 4a.

The prospectus for the IPO included a narrative description of ATV and its business as well as several of ATV's financial statements. C.A. Extract of Record ("ER") Ex. 4.a. Ernst & Young audited ATV's financial statements for the fiscal years ending March 31, 1983 and March 31, 1982. The prospectus also included unaudited quarterly financial statements for the quarters ending June 30, 1983 and June 30, 1982.

ATV had difficulty generating interest in the offering, in part because over the course of 1983 "high-tech IPOs had fallen out of favor with the market." App., *infra*, 4a. As a result, ATV was forced to reduce both the price and the number of shares issued in the IPO, which raised only a fraction of the funds originally contemplated when the prospectus was first prepared. *Id.*

As the court of appeals observed, "[a]ll did not go well" with the new company, and ATV began reporting losses in January 1984. App., *infra*, 3a. The price of its stock fell below $3 (from an offering price of $10). Although it regained "modest profitability" for a time, ATV closed its operations in 1988. *Id.* at 4a-5a.

B. Proceedings at Trial

Respondent Stanley Knapp, a former ATV shareholder, brought this securities fraud class action in 1987 against six ATV officers, two outside directors of the company, 13 venture capital funds that had sold shares in the IPO, ATV's outside legal counsel, E.F. Hutton (the lead underwriter), and Ernst & Young. App., *infra*, 48a. Knapp alleged that the defendants had violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b–5 thereunder.

Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act" in connection with the purchase or sale of securities. *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 114 S.Ct. 1439, 1448 (1994). The language of Section 10(b) does not obscure its emphasis: although "Section 10(b) is aptly described as a catchall provision, * * * what it catches must be fraud." *Id.* at 1447 (internal quotation marks omitted).

On May 31, 1991, Knapp settled for $1.9 million with all of the 24 named defendants except Gomez, O'Connor, and Ernst & Young. App., *infra*, 5a. At plaintiffs' request, the trial was bifurcated to determine class-wide liability issues first, and then to adjudicate the issues of reliance, causation and damages as they applied to individual class members. The first stage of the case was tried against the remaining three defendants in 1992. *Id.*

At trial, Knapp claimed that the following five statements were deceptive or misleading: (1) the narrative portion of the prospectus; (2) the unaudited financial statements for ATV's second quarter ending September 30, 1983; (3) the unaudited financial statements for ATV's first quarter ending June 30, 1983; (4) ATV's audited financial statements for the fiscal year ending March 31, 1983; and (5) Ernst & Young's audit report on ATV's financial statements for the fiscal year ending March 31, 1983. ER 457:10-14.

Knapp asserted that Ernst & Young was liable under Section 10(b) both as a primary violator and for aiding and abetting violations committed by other persons. First, Knapp claimed that Ernst & Young had violated § 10(b) by making fraudulent misrepresentations in the audited financial statements included in the prospectus. App., *infra*, 5a. Specifically, Knapp argued (and his expert witness testified) that the audit report was misleading because Ernst & Young failed to include a "going concern" qualification and also failed to qualify its opinion regarding the collectibility of a $2.7

million receivable from a partnership controlled by the three ATV founders. *Id.* at 5a, 55a.

Second, Knapp claimed that Ernst & Young had "aided and abetted" misrepresentations made by ATV in both the narrative text of the prospectus and in ATV's unaudited quarterly financial statements. App., *infra*, 5a. Knapp argued, and his witnesses testified, that Ernst & Young, by consenting to the inclusion of its audit report in the prospectus, had associated itself with everything in the prospectus. *Id.* at 16a; see, *e.g.*, Tr. 37-41, 774, 1787, 1893-1896, 2324, 4783, 4787-4788. Knapp "presented some evidence suggesting that [petitioner] should have further investigated and distanced itself from ATV's unaudited financial statements." App., *infra*, 5a.

The district court instructed the jury that it could find petitioner liable for securities fraud under either or both of Knapp's legal theories. Thus, the court explained that Ernst & Young could be held liable as a primary violator for making intentional or reckless misrepresentations on its own. App., *infra*, 26a; see, *e.g.*, ER 464:12. And the court also explained that Ernst & Young could be held liable for aiding and abetting misrepresentations made by others. App., *infra*, 41a; *see, e.g.*, ER 464:23.

The jury returned a general verdict against Ernst & Young and the other two defendants. App., *infra*, 5a. The district court then denied Ernst & Young's motions for judgment as a matter of law, or in the alternative, for a new trial. *Id.* at 6a.

After the first phase of the trial but before final judgment, this Court held in *Central Bank of Denver* that there is no private civil liability under Section 10(b) for aiding and abetting the manipulative or deceptive act of another. 114 S. Ct. 1439. In light of this decision, Ernst & Young renewed its motion for a new trial on the ground that the submission

of the invalid aiding-and-abetting theory to the jury required that the case be retried.

The district court denied this motion. App., *infra*, 12a. The court agreed that "[t]he issue of secondary liability certainly is central to this case" (*id.* at 41a), and also acknowledged that it had "erroneously instructed the jury they could find the defendant liable under a secondary theory of liability, aiding and abetting" (*ibid.*). Nevertheless, the court concluded that Ninth Circuit precedent gave it discretion to let the general verdict stand despite the legal invalidity of the aiding and abetting theory and jury instruction. The court exercised that discretion and upheld the verdict on the ground that the legally sound theory of primary liability was "supported by 'substantial evidence' and free from error." *Id.* at 42a.

After completing the second phase of the bifurcated proceeding, the district court awarded nearly $1.6 million in damages. App., *infra*, 22a. More than half of a common fund approaching $3.6 million (including the pre-trial settlement) went to pay plaintiffs' attorneys' fees and expenses. *Id.* at 31a-32a.

C. The Decision of the Ninth Circuit

The court of appeals affirmed. App., *infra*, 1a-20a. The Ninth Circuit acknowledged the "general rule" that a general verdict must be reversed when one of the alternative bases for the verdict is legally erroneous (*id.* at 14a), but it stated that it had "carved out an exception" to that rule. *Id.* Under that exception, if "more than one theory of recovery has been submitted to the jury in a civil case," and if there was "an error of law in submitting [one] theory to the jury," then "the reviewing court has discretion to construe a general verdict as attributable to another theory if it was supported by substantial evidence and was submitted to the jury free from error." *Id.* at 14a-15a (quoting *Traver* v. *Meshriy*, 627 F.2d 934, 938 (9th Cir. 1980)).

The Ninth Circuit accordingly substituted for this Court's bright-line rule an analysis of the following factors to guide the discretionary affirmance of a legally flawed general verdict:

> (1) the potential for confusion of the jury; (2) whether the losing party's defenses apply to the count upon which the verdict is being sustained; (3) the strength of the evidence supporting the count being relied upon to sustain the verdict; and (4) the extent to which the same disputed issues of fact apply to the various legal theories.

App., *infra*, 15a (citing *Counts* v. *Burlington Northern Railroad*, 952 F.2d 1136, 1140 (9th Cir. 1991), and *Portland Feminist Women's Health Center* v. *Advocates for Life, Inc.*, 62 F.3d 280, 285-286 (9th Cir. 1994)).

The Ninth Circuit then concluded that the district court had not abused its discretion in picking through the evidence in this case and deciding that, given the opportunity, the jury would have held Ernst & Young liable for a primary violation if that theory and its supporting evidence alone had been submitted. App., *infra*, 16a-18a. The Ninth Circuit agreed that much of Knapp's evidence, including much of the testimony of his experts, applied to the aiding-and-abetting theory, but stated that the parties had "emphasized" Ernst & Young's "failure to include a going concern qualification." *Id.* at 16a. The court of appeals also found it significant that "Knapp's closing argument * * * mentioned [petitioner's] association with the financial statements as a separate issue." *Id.* According to the Ninth Circuit, "[t]his separation of issues supports the district court's determination." *Id.*

The Ninth Circuit conceded that its "narrow exception has been the target of vigorous and persuasive criticism," and it observed that the Tenth Circuit had recently "revers[ed] a general verdict that could have been based on either primary or secondary liability under Rule 10b–5 because it could not be said with absolute certainty that the jury was not influ-

enced by submission of the improper or erroneous instruction." App., *infra*, 15a (citing *Anixter* v. *Home-Stake Production*, 77 F.3d 1215, 1229 (10th Cir. 1996) (internal quotation marks omitted)). The court below nonetheless held that it was bound by "the law in our circuit," and had no choice but to afford the district court "the discretion to [affirm the general verdict] if it found that substantial evidence supported a primary theory of liability." *Id.*

REASONS FOR GRANTING THE PETITION

This case presents the question of the proper appellate treatment of a civil general jury verdict that may be the product of an erroneous legal theory. This Court seemingly settled the issue a century ago, stating the civil general verdict rule in these clear terms: "If * * * upon any one issue error was committed, either in the admission of evidence, or in the charge of the court, the verdict cannot be upheld." *Maryland* v. *Baldwin*, 112 U.S. 490, 493 (1884). The reason for this rule is equally clear: the "generality" of the verdict "prevents" a reviewing court "from perceiving upon which plea [the jury] found," and "it may be that * * * the jury were controlled" by the faulty "instructions given." *Ibid.* Twice since 1990 this Court again has unmistakably confirmed that a "jury's general verdict * * * *cannot be permitted to stand*" if it is "based on instructions that erroneously permitted liability." *City of Columbia* v. *Omni Outdoor Advertising, Inc.*, 499 U.S. 365, 384 (1991) (emphasis added). See *Spectrum Sports, Inc.* v. *McQuillan*, 506 U.S. 447, 456 (1993).

The Ninth Circuit does not agree with this Court that in those circumstances "there is no way to know that the invalid claim * * * was not the sole basis for the verdict." *United New York & New Jersey Sandy Hook Pilots Ass'n* v. *Halecki*, 358 U.S. 613, 619 (1959). Rather, the Ninth Circuit purports to read the jury's mind, using a four-part analysis that it described in an unguarded moment as "*ad hoc*." *Hendry* v. *Exide Electronics Corp.*, 974 F.2d 1342 (table), 1992 WL

217785 (9th Cir. 1992) (unpublished opinion) (reprinted in App., *infra*, 70a-88a). That idiosyncratic rule predictably leads to idiosyncratic results: the decision below conflicts not only with the result mandated by this Court's general verdict rule, but also with a decision of the Tenth Circuit in an almost identical case of an outside auditor's purported liability for securities fraud. *Anixter* v. *Home-Stake Production*, 77 F.3d 1215 (10th Cir. 1996).

This Court should grant the petition for four compelling reasons. First, the decision below conflicts with this Court's unqualified rule that a general verdict resting on a legally erroneous alternate theory cannot stand. Second, not only does the decision below conflict with decisions in other circuits, but the conflict among the circuits is deep — unjustifiably so, given this Court's unambiguous and repeated holdings. Third, the treatment of flawed civil general verdicts is an issue of recurring importance because general jury verdicts remain the prevalent form of decision in the district courts. Fourth, the decision below is incompatible not only with the precedents of this Court but also with sound jurisprudence. The Ninth Circuit has replaced a venerable bright-line rule with a fog of judicial discretion that is unpredictable both in principle and in practice.

I. THE DECISION OF THE NINTH CIRCUIT CONFLICTS WITH THIS COURT'S CIVIL GENERAL VERDICT RULE

A. More than a century ago, this Court seemingly settled the issue of the proper appellate treatment of a civil general jury verdict that is the product of both an erroneous and a sound legal theory. The Court established an absolute and unambiguous rule that a general jury verdict *must* be reversed if "upon any one issue error was committed, either in the admission of evidence, or in the charge of the court." *Baldwin*, 112 U.S. at 493. In *Baldwin*, the Court reversed a defense judgment because of the admission of hearsay pertaining to one of several defenses. This Court has repeatedly

reaffirmed the *Baldwin* civil general verdict rule without the slightest divergence.

For example, in *United New York and New Jersey Sandy Hook Pilots Association* v. *Halecki*, 358 U.S. 613 (1959), the Court reversed a plaintiff's judgment on a general verdict where the case had been submitted on a strict liability theory of unseaworthiness and an alternative theory of negligence. Although each theory was supported by the evidence, the Court held that the protections of the unseaworthiness doctrine did not extend to the plaintiff. *Id.* at 617. The Court thus concluded that "a new trial will be required, for there is no way to know that the invalid claim of unseaworthiness was not the sole basis for the verdict." *Id.* at 619.

A few years later, the Court considered an antitrust case in which the jury had been instructed that it could find that the two defendant agricultural cooperatives had illegally conspired with any of several identified co-conspirators, one of which was a third agricultural cooperative. *Sunkist Growers, Inc.* v. *Winckler & Smith Citrus Products Co.*, 370 U.S. 19 (1962). The Court held that the antitrust laws did not forbid concerted action limited to the three cooperatives (which had largely identical memberships). *Id.* at 27. Although the Court acknowledged that the defendant cooperatives could be held liable on the other theories presented to the jury — conspiracy with outsiders and monopolization — and although the plaintiff's theory made little sense unless the cooperatives had also conspired with some of those outsiders (who were the plaintiff's competitors), the Court concluded that it was "unnecessary * * * to explore the legality of the other theories" as they applied to the *Sunkist* case. *Id.* at 30. Quoting *Baldwin* (112 U.S. at 493), the Court instead reiterated that the "generality" of a general verdict "prevents [the Court] from perceiving upon which plea [the jury] found." *Ibid.* at 30 (internal quotation marks omitted). As in *Baldwin*, error "upon any one issue * * * in the admission of evidence, or in the charge of the court," compelled the

conclusion that "the verdict cannot be upheld." *Ibid* (internal quotation marks omitted).

Twice in this decade, this Court has reaffirmed its civil general verdict rule in cases involving legal error. In 1991, the Court held (again in an antitrust case in which one theory was legally invalid) that "the jury's general verdict * * * cannot be permitted to stand (since it was based on instructions that erroneously permitted liability * * *)." *Omni*, 499 U.S. at 384. And in 1993, the Court again reversed a judgment based on a general verdict that the defendants had violated the antitrust laws by "monopolizing, attempting to monopolize, and/or conspiring to monopolize." *Spectrum Sports*, 506 U.S. at 451 (quoting verdict sheet). The Court examined (and found wanting) only the jury instructions on *attempted* monopolization but, citing *Sunkist*, reversed the judgment because "the jury's verdict did not negate the possibility that the * * * verdict rested on the attempt to monopolize ground alone." *Id.* at 459.

B. This Court's civil general verdict rule is unmistakably clear: a general verdict that *may* have been founded on an erroneous legal theory *must* be reversed. And it is equally clear that, unless and until this Court overrules *Spectrum, Omni, Sunkist, Baldwin*, and the rest, the courts of appeals are bound by those precedents. See *Rodriguez de Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989).

The Ninth Circuit apparently does not agree. Engaging in an "indefensible brand of judicial activism" (*Rodriguez de Quijas*, 490 U.S. at 486 (Stevens, J., dissenting)), the Ninth Circuit has taken it upon itself to "carve out an exception" to this Court's firm rule (App., *infra*, 14a), in full awareness that its approach is "contrary to Supreme Court precedent." *Hendry*, App., *infra*, 75a n.7.

As we have explained, this Court has repeatedly held that a general verdict that may have been based on a legally erroneous theory simply "*cannot* be upheld" (*Sunkist*, 370

U.S. at 30; *Baldwin*, 112 U.S. at 493 (emphasis added)) and "*cannot be permitted to stand.*" *Omni*, 499 U.S. at 384 (emphasis added). The Court has not so much as hinted at an exception of any kind. By contrast, in the Ninth Circuit the decision to uphold or to set aside a legally flawed general verdict is "*entirely discretionary.*" App., *infra*, 14a (emphasis added). The court below declared that, even though "there was * * * an error of law in submitting the theory to the jury," a court "has discretion to construe a general verdict as attributable to another theory if it was supported by substantial evidence and was submitted to the jury free from error." *Id.* at 14a-15a (quoting *Traver* v. *Meshriy*, 627 F.2d 934, 938 (9th Cir. 1980).

Eschewing this Court's bright-line rule, the Ninth Circuit instead embarks on a four-part inquiry encompassing

> (1) the potential for confusion of the jury, (2) whether the losing party's defenses apply to the count upon which the verdict is being sustained, (3) the strength of the evidence supporting the count relied upon to sustain the verdict, and (4) the extent to which the same disputed issues of fact apply to the various legal theories.

App., *infra*, 15a. See *id.* at 16a-18a (applying factors). See also *Counts* v. *Burlington Northern*, 952 F.2d at 1140. There is no consistent structure to this "entirely discretionary" exercise. For that reason, the Ninth Circuit has conceded that its approach is essentially "*ad hoc.*" *Hendry*, App., *infra*, 76a.

Neither the amorphousness of its rule nor the conflict with this Court's precedents has disturbed the Ninth Circuit. Indeed, the court below has recognized and rejected the "vigorous and persuasive criticism" aimed at its practice. App., *infra*, 15a. Moreover, the court has expressly refused to consider whether this Court's recent reaffirmance of its civil general verdict rule in *Omni* "calls into question the continued validity of th[e Ninth] Circuit's exception to the

general rule," because the Ninth Circuit has "been aware that this exception is contrary to Supreme Court precedent since well before" *Omni* was decided. *Hendry*, App., *infra*, 75a n.7.

The Ninth Circuit's answer to the conflict between its rule and this Court's unbroken line of precedents always has been that the spurious exception "is the law in our circuit." App., *infra*, 15a. See also *Hendry*, App., *infra*, 75a-76a n.7. That refusal to recognize and accede to the hierarchy of authority in the federal courts warrants this Court's review.

II. THE CIRCUITS ARE DIVIDED IN THEIR STANDARDS FOR REVIEWING CIVIL GENERAL JURY VERDICTS

A recent commentary observed that "[t]he discretionary Ninth Circuit rule is completely incompatible * * * with the rule applied in every circuit which has addressed the issue." Axelrad & Kraus, *The Federal General Verdict Rule: Conflict in the Courts of Appeal*, 43 FED. LAW. 43, 44 (June 1996). Although it is true that "[t]he Courts of Appeals other than the Ninth Circuit" by and large "have followed th[e] approach" set forth by this Court, *Spectrum Sports, Inc.* v. *McQuillan*, 506 U.S. 447, 456 (1993), the divisions among the circuits are deeper than the commentary suggests.

The disagreement with the Ninth Circuit is clearest among those courts of appeals that have not found any case warranting an exception to the rule. At least five courts of appeals take this Court at its word, and routinely overturn any general verdict that is undermined by legal error on one of the alternative theories supporting it. *McKenna* v. *Pacific Rail Service*, 32 F.3d 820, 832 (3d Cir. 1994); *Harwood* v. *Partredereit AF*, 944 F.2d 1187, 1192-1193 (4th Cir. 1991), cert. denied, 503 U.S. 907 (1992); *Reeves* v. *Acro Medical Corp.*, 44 F.3d 300, 302-303 (5th Cir. 1995); *In re Air Crash Disaster*, 86 F.3d 498, 544 (6th Cir. 1996); *Founding Church of Scientology* v. *United States*, 409 F.2d 1146, 1161, 1164

(D.C. Cir.), cert. denied, 396 U.S. 963 (1969).[1] Those decisions squarely conflict with the decision below.

The Ninth Circuit is not alone, however, in its failure to adhere to the rule enunciated in *Baldwin* and confirmed in *Omni* and *Spectrum Sports*. The Seventh Circuit, without citing authority, has stated and applied a harmless error exception to the general verdict rule in a case in which the jury was instructed on a legally invalid theory. *Collum* v. *Butler*, 421 F.2d 1257, 1260 (7th Cir. 1970). Despite the legal insufficiency of two out of three theories of liability under 42 U.S.C. § 1983, the *Collum* court upheld the verdict based on the court's "considered opinion" that "the results of the present trial would not have been substantially affected if these issues had not been submitted to the jury." *Id.* at 1260. In other cases, the Seventh Circuit not only has ignored this Court's precedent, but has stated a rule that stands this Court's civil general verdict rule on its head: "[T]o triumph on appeal, defendants must show that under none of the [alternative] rationales [supporting a general verdict] was plaintiff entitled" to judgment. *McGrath* v. *Zenith Radio*

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[1] The Fourth Circuit has recognized an exception that would apply only if "answers to interrogatories accompanying the verdict" indicated "on which theory the jury reached its decision" (*Harwood*, 944 F.2d at 1193), but the use of interrogatories would take a case outside the general verdict rule — unless, of course, the interrogatories themselves permitted the jury to rely on either a legally sound or a legally infirm theory. See note 2, *infra*. The Second and Eighth Circuits, although professing to permit broader exceptions (see page 16, *infra*), have indicated that in cases of legal error any exception to the rule of reversal likewise may be limited to cases involving special interrogatories. *O'Neill* v. *Krzeminski*, 839 F.2d 9, 12 (2d Cir. 1988); *Tioga Public School District #15* v. *United States Gypsum Co.*, 984 F.2d 915, 921-922 (8th Cir. 1993). The Eleventh Circuit, by contrast, has stated the rule in absolute terms, but proceeded to determine whether a judgment could stand even though the jury had considered one theory of liability that was barred by the statute of limitations. *Grant* v. *Preferred Research, Inc.*, 885 F.2d 795, 799-800 (1989) (granting new trial).

Corp., 651 F.2d 458, 464 (7th Cir.) (finding all theories factually and legally sound), cert. denied, 454 U.S. 835 (1981); *Cross* v. *Ryan*, 124 F.2d 883, 887 (7th Cir. 1941) ("[I]f there is substantial evidence to sustain any one count in favor of each plaintiff, the general verdict must be upheld."), cert. denied, 316 U.S. 682 (1942).

In addition, several courts of appeals expressly recognize the controlling standard, but have applied or articulated "harmless error" exceptions to the general rule. The First Circuit subjects legal errors affecting one alternative theory supporting a general verdict to the same harmless error analysis it developed for evidentiary insufficiency in that situation. See *Kassel* v. *Gannett Co.*, 875 F.2d 935, 950 (1st Cir. 1989) (citing *Brochu* v. *Ortho Pharmaceutical Corp.*, 642 F.2d 652, 662 (1st Cir. 1981)).[2] Under that test, an error is harmless only when the elements required to establish the sound theory of liability are a subset of the elements necessary to establish the unsupported theory. As Judge Kozinski pointed out in criticizing the Ninth Circuit's discretionary practice, the exception applied in *Brochu* may be "fully consistent" with this Court's rule. *Kern* v. *Levolor Lorentzen, Inc.*, 899 F.2d 772, 790 (9th Cir. 1990) (dissenting opinion). The Ninth Circuit's exception, by contrast, is not.

Other courts of appeals have suggested that they might uphold a general verdict even in the face of legal error if they

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[2] The First Circuit recently restated its rule and extended it to a "special" verdict that consisted of a form asking for three general factual determinations by a jury that had been instructed on four legal theories, of which two were legally barred and one was factually unsupported. *Lattimore* v. *Polaroid Corp.*, ___ F.3d ___, 1996 WL 625455, at *11-*12 (1st Cir. Nov. 5, 1996). The First Circuit, again citing *Brochu*, stated that it is "settled law that, when multiple claims are submitted and only a general verdict is returned, a new trial is required if some of the claims should not have been submitted and the jury's consideration of those claims may have affected the verdict." *Id.* at *11.

are "fairly convinced" that the jury verdict was based on the correct theory. *E.g.*, *Mueller* v. *Hubbard Milling Co.*, 573 F.2d 1029, 1039 (8th Cir.), cert. denied, 439 U.S. 865 (1978); *Morrissey* v. *National Maritime Union of America*, 544 F.2d 19, 27 (2d Cir. 1976). That standard would allow a reviewing court nearly the same range of discretion as the Ninth Circuit affords itself. The other courts, however, have recognized that any "qualification on the general rule * * * must be kept within rather strict bounds." *Morrissey*, 544 F.2d at 27. Indeed, the Eighth Circuit made clear that the exception can apply in cases of legal error only if the jury instructions in some way "restrict[ed] the jury" to reaching its verdict on the sustainable ground, for example by allowing punitive damages to be awarded only under the sound theory. *Tioga Public School District #15* v. *United States Gypsum Co.*, 984 F.2d 915, 921-922 (8th Cir. 1993).

Moreover, the Tenth Circuit, which formerly applied a broad exception, now "adhere[s] strictly to the general rule and ha[s] remanded cases where [it] could not say with *absolute* certainty that the jury was not influenced by the submission of the improper or erroneous instruction." *Anixter* v. *Home-Stake Production*, 77 F.3d 1215, 1229 (10th Cir. 1996) (emphasis added) (internal quotation marks omitted). That narrow exception, limited to cases providing "absolute certainty," places the Tenth Circuit firmly in conflict with the court below.

2. The conflict in *this* case is sharper still than the general conflict among the circuits. As the court below recognized, its decision cannot possibly be reconciled with the decision of the Tenth Circuit in an indistinguishable case. See App., *infra*, 15a (citing *Anixter*, 77 F.3d 1215). In *Anixter*, as in this case, an outside auditor was held liable for violations of Rule 10b-5. In *Anixter*, as in this case, the district court had instructed the jury on both primary and aiding-and-abetting liability. In *Anixter*, as in this case, the district court denied the auditor's motion for a new trial, even

though this Court had held in *Central Bank* that there was no private action for aiding and abetting a violation of Rule 10b–5. See 77 F.3d at 1221-1222.

But rather than emulating the Ninth Circuit's attempt to read the jury's mind, the Tenth Circuit in *Anixter* followed this Court's rule. In stark contrast with the Ninth Circuit's decision in this case, the Tenth Circuit reversed the judgment because it could not say "with absolute certainty that the jury was not influenced by the submission of the improper or erroneous instruction." 77 F.3d at 1229 (internal quotation marks omitted). As the Tenth Circuit recognized, in "analyzing accountant behavior under § 10(b)," the "distinctions in conduct between primary and secondary liability are elusive." *Id.* at 1230. The Tenth Circuit reached this conclusion even though the bulk of the evidence involved the auditor's acts as an alleged primary violator, and even though the risk of jury confusion may have been remote. *Id.* at 1230-1231.

There is no principled distinction between *Anixter* and this case. The general verdict in each case "shed no light" on whether the jury found the outside auditor liable on a proper or improper legal theory. *Anixter*, 77 F.3d at 1230. The only difference is that the Ninth Circuit viewed the question whether to affirm a flawed general verdict as "entirely discretionary" (App., *infra*, 14a), while the Tenth Circuit adhered to this Court's rule in the absence of an "absolutely certain" indication that the jury verdict rested on the legally tenable ground.

Despite the seeming clarity of this Court's repeated holdings, the circuits have divided over the proper scope and application of the general verdict rule. Review by this Court is warranted to resolve that conflict.

III. THE STANDARD FOR THE APPELLATE REVIEW OF A CIVIL GENERAL JURY VERDICT PRESENTS A QUESTION OF EXCEPTIONAL AND RECURRING IMPORTANCE

The recurring importance of the issue presented in this case is obvious: the use of general verdicts is an established and sanctioned practice in the federal courts. Indeed, "[m]ost jury-tried civil cases in federal courts are resolved, and always have been, by a general verdict." 9A WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE § 2501, at 484 (1971); accord FRIEDENTHAL, KANE & MILLER, CIVIL PROCEDURE § 12.1, at 532 (2d ed. 1993); Axelrad & Kraus, *supra*, at 43. By contrast, the special verdict form, and the general verdict form with interrogatories, are used relatively infrequently. WRIGHT & MILLER, *supra*, § 2505, at 498. This is equally true in litigation involving multiple theories or claims. Note, *General Verdicts in Multi-Claim Litigation*, 21 MEM. ST. U. L. REV. 705, 706 (1991).

There is no reason to expect this practice to change. The choice of verdict form "rests with the discretion of the trial court," and that discretion is "very broad," if not "unreviewable." WRIGHT & MILLER, *supra*, § 2511, at 522. District courts — which work with juries on a daily basis — have come to prefer general verdicts in the run of cases, whether complex or simple, and are likely to continue to rely primarily on the general verdict form in the future. See *id.* § 2505, at 498. Recent history confirms this prevalence: the courts of appeals have addressed the question presented in this case again and again.[3]

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[3] *E.g.*, *Kassel* v. *Gannett Co.*, 875 F.2d 935, 950 (1st Cir. 1989); *BAII Banking Corp.* v. *UPG, Inc.*, 985 F.2d 685, 704 (2d Cir. 1993); *O'Neill* v. *Krzeminski*, 839 F.2d 9, 12 (2d Cir. 1988); *McKenna* v. *Pacific Rail Service*, 32 F.3d 820, 832 (3d Cir. 1994); *Carden* v. *Westinghouse Electric Corp.*, 850 F.2d 996, 1001, 1004 (3d Cir. 1988); *Harwood* v. *Partredereit AF*, 944 F.2d 1187, 1192-1193 (4th

Moreover, the civil general verdict rule is not some ancillary aspect of appellate procedure. To the contrary, the "standard for reviewing a general verdict * * * can affect the outcome of an appeal more dramatically and fundamentally than virtually any other rule applied in the course of the litigation." Axelrad & Kraus, *supra*, at 43. The conflicting rules applied to civil general jury verdicts can be dispositive of any appeal in which legal error invalidates less than all of the alternative bases of liability supporting a general jury verdict. As the conflict between this case and *Anixter* amply demonstrates, the same appeal would be decided differently depending on the circuit in which the case was filed.

Indeed, the forum-shopping implications are quite plain. In the Ninth and Seventh Circuits, and perhaps in others as well, a plaintiff may take a kitchen-sink approach in an attempt to weigh down the defense with alternate theories of liability, with a greatly reduced risk of reversal even if some of those theories are held to be legally unsound.

In sum, the prevalence of general jury verdicts in federal trial courts makes apparent "the need for a uniform rule on

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Cir. 1991), cert. denied, 503 U.S. 907 (1992); *Reeves* v. *Acro Medical Corp.*, 44 F.3d 300, 302-303 (5th Cir.), cert. denied, 115 S. Ct. 2251 (1995); *Crist* v. *Dickson Welding, Inc.*, 957 F.2d 1281, 1286-1288 (5th Cir.), cert. denied, 506 U.S. 864 (1992); *Nowell ex rel. Nowell* v. *Universal Electric Co.*, 792 F.2d 1310, 1312 (5th Cir.), cert. denied, 479 U.S. 987 (1986); *In re Air Crash Disaster*, 86 F.3d 498, 544 (6th Cir. 1996); *Brandenburg* v. *Cureton*, 882 F.2d 211, 214 (6th Cir. 1989); *Tioga Public School District #15* v. *United States Gypsum Co.*, 984 F.2d 915, 921-922 (8th Cir. 1993); *Bone* v. *Refco, Inc.*, 774 F.2d 235, 242-243 (8th Cir. 1985); *Portland Feminist Women's Health Center* v. *Advocates for Life, Inc.*, 62 F.3d 280, 285-286 (9th Cir. 1994); *Anixter* v. *Home-Stake Production*, 77 F.3d 1215, 1229-1231 (10th Cir. 1996); *Narey* v. *Dean*, 32 F.3d 1521, 1528 (11th Cir. 1994); *Grant* v. *Preferred Research, Inc.*, 885 F.2d 795, 799-800 (11th Cir. 1989); *Kuwait Airways Corp.* v. *American Security Bank, N.A.*, 890 F.2d 456, 458 (D.C. Cir. 1989).

the point" presented in this case. *Commissioner* v. *Bilder*, 369 U.S. 499, 501 (1962). Review is therefore warranted.

IV. THE DECISION OF THE NINTH CIRCUIT IS ERRONEOUS

This case warrants further review for the additional reason that the discretionary practice of the Ninth Circuit is as wanting in logic as it is in precedential support. As the Ninth Circuit has acknowledged, its spurious exception to this Court's binding rule "has been the target of vigorous and persuasive criticism." App., *infra*, 15a (citing *Kern*, 899 F.2d at 789-792 (Kozinski, J., dissenting)). As we show below, that "persuasive criticism" is well-deserved. Moreover, even if this Court's bright-line rule admitted any exceptions, no principled exception could apply to this case. To the contrary, this case — in which the question of the liability of an independent auditor for securities fraud was submitted to the jury on theories of primary fraud and of aiding and abetting the fraud of the issuer/client — provides a textbook example supporting the rationale underlying this Court's traditional civil general verdict rule.

A. This Court's Absolute Rule "Makes Good Sense"

To begin with, as this Court has recognized, *no* reviewing court possesses the necessary mind-reading power that would allow it to "perceiv[e]" the basis of a general jury verdict. *Sunkist*, 370 U.S. at 30. By its nature, a general verdict "is as inscrutable and essentially mysterious as the judgment which issued from the ancient oracle at Delphi." Sunderland, *Verdicts, General and Special*, 29 YALE L.J. 253, 258 (1920). A reviewing court simply cannot know with any certainty whether the invalid ground contributed to, or wholly supported, the verdict. See *Baldwin*, 112 U.S. at 493.

1. This Court recently elaborated upon the reasoning behind the general verdict rule of automatic reversal for legal error. In *Griffin* v. *United States*, 502 U.S. 46 (1991), the

Court held that, where a jury has considered alternative theories of liability, a general verdict in a criminal case may stand if its only flaw is a want of sufficient evidence to support one (but not all) theories. But the Court painstakingly distinguished this *factual* error from the *legal* error that results when the jury is allowed to consider a theory that is invalid as a matter of law. *Id.* at 58-59. Legal error, the Court observed, requires reversal for a new trial. *Id.* at 59.

The Court explained why the rule of reversal "makes good sense" when the error is *legal* rather than *factual*. 502 U.S. at 59. Although "jurors are well equipped to analyze the evidence," they "are not generally equipped to determine whether a particular theory * * * submitted to them is contrary to law — whether, for example," the challenged conduct "fails to come within the statutory definition of the crime." *Ibid.* Jurors presumably will prefer the factually strongest claims over the unsupported ones, but when they "have been left the option of relying upon a legally inadequate theory, there is no reason to think that their own intelligence and expertise will save them from that error." *Ibid.*

The logic of *Griffin* applies equally in the civil context. A general verdict is as inscrutable in a civil case as in a criminal case, and a juror in a civil trial is no better "equipped" than a juror in a criminal trial to "determine whether a particular theory" of liability "is contrary to law." 502 U.S. at 59.

2. This Court's civil general verdict rule rests not merely on logic, but on experience as well. Both the rule and its supporting rationale are firmly rooted in the common law. Long before the creation of the federal courts, the English courts held that a court must reverse a general verdict and allow a new trial where the jury had been presented with theories some of which were actionable and "some not actionable." *Eddowes* v. *Hopkins*, 99 Eng. Rep. 242, 243, 1 Dougl. 376, 377 (1780). The reasoning was identical to this Court's view in *Griffin* more than two centuries later: "it

would be impossible for the Judge to say, on which of the counts the jury had found the damages, or how they had apportioned them." *Ibid.* And the rule was venerable long before 1780. See *Anger* v. *Wilkins*, Barnes 478, 94 Eng. Rep. 1012 (6 Geo. 2 [1732/3]) (new trial allowed "according to an ancient rule of Court" after reversal of partially flawed general verdict).

B. The Ninth Circuit's Discretionary Practice Is Illogical And Unworkable

The Ninth Circuit's *ad hoc* practice, by contrast, undermines the predictability that, as Justice Holmes recognized, is the essence of law. See Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 457-458, 461 (1897). In the Ninth Circuit, the discretion of a district judge second-guessing a jury — or the discretion of two judges on an appellate panel — "ha[s] now submerged the rule" announced by this Court. *Kern*, 899 F.2d at 791 (Kozinski, J., dissenting).

There is no analytic rigor, but only subjective judicial reaction, in the Ninth Circuit's discretionary approach. Its bottom line is that a general verdict may be sustained regardless of legal error whenever *one* theory of liability is "supported by substantial evidence and was submitted to the jury free from error." App., *infra*, 14a. In other words, the court below affords itself (and its district courts) the "discretion" to stand this Court's rule on its head. As Judge Kozinski has observed, the Ninth Circuit thus has "ero[ded] a perfectly good rule" (*Kern*, 899 F.2d at 791 (Kozinski, J., dissenting)), and has replaced it with an "entirely discretionary" morass (App., *infra*, 14a).

C. There Is No Logical Exception To The Court's Rule That Could Encompass This Case

In the 112 years since it decided *Baldwin*, this Court has never suggested that there are any exceptions to the rule requiring a new trial whenever legal error infects one of two or more alternative theories presented to the jury in support

of a general verdict. But even if the rule were not absolute, no "harmless error" exception that is consistent with the rationale of the rule would apply to this case.

The civil general verdict rule rests on the indisputable observation that, when a jury is given both valid and invalid methods to hold a defendant liable but responds only that the defendant *is* liable, "there is no way to know that the invalid claim * * * was not the sole basis for the verdict." *Halecki*, 358 U.S. at 619. As this Court explained, the "generality" of a verdict "prevents" *any* appellate court "from perceiving upon which" theory the jury "found." *Baldwin*, 112 U.S. at 493. If, as in the present case, the jury was instructed that it could hold a defendant liable by finding facts that as a matter of law do not result in liability, certainly "it may be that * * * the jury" rendered its verdict "under the instructions given." *Ibid.* Although jurors are the paramount evaluators of facts under our system, they simply "are not generally equipped to determine whether a particular theory * * * submitted to them is contrary to law — whether, for example," as in this case, "the action in question * * * fails to come within the statutory definition" of a violation. *Griffin*, 502 U.S. at 59.

If there were a harmless error exception to this Court's civil general verdict rule, it would have to be consistent with the reasoning of the rule. Perhaps, in some cases, "the jury's verdict" on its face may "*negate* the possibility that the * * * verdict rested" on the invalid ground alone. *Spectrum Sports*, 506 U.S. at 459. The narrow exception that the First Circuit acknowledged in *Brochu* could come within this class. If, as in *Brochu*, "the elements needed" for two claims entirely "corresponded," except that one claim "required an additional element," and if (for example) the jury was erroneously instructed only with respect to that additional element, then the *necessary* implication from the jury's verdict would be that the elements of the untainted claim had been proved. 642 F.2d at 662. A similar situation could

arise where jury interrogatories submitted under Rule 49(b) of the Federal Rules of Civil Procedure allowed a reviewing court to "perceiv[e]" with certainty "upon which plea" the jury necessarily "found." *Baldwin*, 112 U.S. at 493. See, *e.g.*, *Harwood*, 944 F.2d at 1193; see also note 1, *supra*.

But a court can uphold a general verdict despite legal error only when by logical necessity the verdict on its face "negate[s] the possibility" that it rested on an invalid ground. *Spectrum Sports*, 506 U.S. at 459. Anything less than "absolute certainty" (*Anixter*, 77 F.3d at 1229) not only would undermine the integrity of a procedural protection rooted in more than a century of federal practice and a far longer common law tradition, but would also trench upon a litigant's Seventh Amendment right to have a jury, rather than the *ad hoc* hindsight of a court, determine each and every element of a dispositive claim or defense. See *Markman* v. *Westview Instruments, Inc.*, 116 S. Ct. 1384, 1389-1390 (1996); *Lytle* v. *Household Manufacturing, Inc.*, 494 U.S. 545, 554-555 (1990).

The Ninth Circuit's four-step inquiry does not lead to the conclusion that the jury *must* have reached its verdict on a valid ground. At most, that *ad hoc* examination of (a) the potential for jury confusion, (b) the abstract applicability of defenses to valid and invalid claims alike, (c) the strength of the evidence supporting the valid claim, and (d) the overlap of disputed issues of fact between the valid and invalid claims may lead to the conclusion that the jury *might* have relied on the valid claim. That inquiry does not "negate the possibility" that the jury concluded its deliberations upon finding only that the elements of the invalid claim had been proved, much less account for the substantial differences in evidence that may result from a defendant's having to contend with a broad but legally invalid claim.

Indeed, the facts of this very case vividly demonstrate the weaknesses of the Ninth Circuit's test. Although the courts below exercised their discretion to uphold the $1.6 million

verdict, it is impossible to say with any confidence that the jury held Ernst & Young liable for securities fraud on a theory of primary liability rather than aiding and abetting.

To begin with, as the Ninth Circuit pointed out, the actual statements identified as bases for primary liability were different from those identified as bases for secondary liability. There is no way to know from the jury verdict whether the jury found that those elements of a Rule 10b-5 violation that reflect, not the knowledge and motivation of the *actor*, but the nature and effect of the *statement* — that is, materiality, reliance, and causation — applied to the audited financial statements as well as to the prospectus narrative and the unaudited statements. See *Central Bank*, 114 S. Ct. at 1455; see also *Anixter*, 77 F.3d at 1225 (opining that the "critical element separating primary from aiding and abetting violations is the existence of a representation * * * made by the defendant, that is relied upon by the plaintiff"). Particularly with respect to "accountant behavior," the "distinctions in conduct between primary and secondary liability are elusive," but they are also "pivotal." *Id.* at 1230.

In addition, the standard for aiding-and-abetting liability that was presented to the jury was substantially lower than the standard for primary liability, particularly with respect to the important element of *scienter*. See Feldman, *The Breakdown of Securities Fraud Aiding and Abetting Liability: Can a Uniform Standard Be Resurrected?*, 19 SEC. REG. L.J. 45, 45-46, 64 (1991) (noting that "[t]he Ninth Circuit ha[d] developed the most liberal aiding and abetting standard").[4] Speci-

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[4] For that reason, before this Court decided *Central Bank*, plaintiffs regularly relied on aiding-and-abetting theories to bring Rule 10b-5 claims against accountants, regardless of whether there was a tenable claim for primary liability as well. See Feldman, *supra*, 19 SEC. REG. L.J. at 45-46, 72-73. "Often the only viable theory * * * to obtain securities fraud liability" against an accountant was aiding and abetting (*id.* at 45), and certainly that theory had more intuitive appeal than a

fically, the jury was told that primary liability required proof of *scienter* — for all practical purposes, recklessness, as the record was "devoid" of evidence of intentional fraud (App., *infra*, 19a) — with respect to the making and the deceptiveness of a material misstatement or omission itself. By contrast, the jury was instructed that it could hold Ernst & Young liable for aiding and abetting if Ernst & Young "had * * * reckless disregard of the conduct constituting the primary violation" or, if it was actually unaware of a misrepresentation, "acted with reckless disregard for whether the primary violation would be furthered" (Tr. 4742). This attenuated culpability — recklessness about another's recklessness — is a far cry from the "knowing or intentional misconduct" proscribed by Section 10(b) (*Central Bank*, 114 S.Ct. at 1446) (internal quotation marks omitted) and presents a far easier ground for jury agreement. The jury had only to find that Ernst & Young provided a "degree of aid" to a violation, without even knowing that it was doing so. *Id.* at 1447. See *id.* at 1455-1456 (criticizing SEC's advocacy of recklessness standard of *scienter* for aiding and abetting).

As the Tenth Circuit recognized under identical circumstances, "[t]he general verdict[]" *itself* "shed no light on whether the jury found [the auditor] liable because of his substantial assistance to [his client's] independent fraudulent acts, or whether his liability rested on actual representations he made that reached investors." *Anixter*, 77 F.3d at 1230-1231. It is not for a court to tease out, *post hoc*, what the jury found — much less to determine, as the Ninth Circuit did in this case, simply that it would have been both possible and

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claim that an ancillary participant in a securities offering was primarily liable. See Humphreys, *Aiding and Abetting Liability of Accountants in Securities Fraud Cases*, 17 SEC. REG. L.J. 375, 397 (1990) (noting that, for an accountant, the "misfortune of having an audit client engaged in a fraud" was "a virtual guarantee of an aiding and abetting claim").

permissible for the jury to have found primary liability as well as, or instead of, secondary liability. Thus, even if this Court were inclined to abandon its century-old rule of automatic reversal and substitute some form of harmless error analysis, Ernst & Young would still be entitled to a new trial.

* * * * *

The rule adopted by this Court and followed by the majority of the courts of appeals "makes good sense" and is firmly rooted in our legal tradition. Neither can be said for the "entirely discretionary" exercise performed below. This Court's review is essential to ensure that the circuits consistently and uniformly apply a single civil general verdict rule when faced with errors on appeal.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 1996

APPENDICES

APPENDIX A

United States Court of Appeals,
Ninth Circuit.

Nos. 94-56379, 94-56380 and 94-56381.

Stanley KNAPP, on behalf of himself and all others similarly situated,
Plaintiff-Appellee,

v.

ERNST & WHINNEY, Defendant-Appellant.

Stanley KNAPP, on behalf of himself and all others similarly situated,
Plaintiff-Appellee,

v.

Philip J. GOMEZ; Douglas J. O'Connor,
Defendants-Appellants.

Stanley KNAPP, on behalf of himself and all others similarly situated,
Plaintiff-Appellant,

v.

Philip J. GOMEZ; Douglas J. O'Connor; Ernst & Whinney, Defendants-Appellees.

Argued and Submitted
Feb. 6, 1996 (94-56379).
Submitted Feb. 6, 1996
(94-56380 & 94-56381).*

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* The panel unanimously finds this case suitable for decision without oral argument. Fed. R. App. P. 34(a) and Ninth Circuit

Decided July 23, 1996.

Before: WALLACE, FERGUSON and T.G. NELSON, *Circuit Judges*.

WALLACE, *Circuit Judge*:

Ernst & Whinney appeals from a general jury verdict in favor of the plaintiff class (Knapp). Knapp cross-appeals from the district court's denial of prejudgment interest and the dismissal of various state-law causes of action. The district court had jurisdiction pursuant to 15 U.S.C. § 78aa and 28 U.S.C. § 1331. We have jurisdiction over this timely appeal pursuant to 28 U.S.C. § 1291. We affirm.

I

ATV Systems, Inc. (ATV) was founded by Philip Gomez, Douglas O'Connor, and Frank Gleason in 1981. The company specialized in point-of-sale microprocessing systems designed for retail applications and also dealt in more generalized data processing and communications equipment for office use. The principals had been involved in the high-tech field and considered themselves well-versed in "turn-around" techniques. They were experienced in taking troubled companies, slashing waste, increasing productivity, improving the bottom line, and turning the companies into profitable enterprises. There were many businesses in need of such redirection in the early 1980s because interest rates were high and credit was tight. ATV's business plan was to acquire bankrupt companies at bargain prices, liquidate unprofitable product lines, and merge profitable lines into its own operations.

Although this mode of operation allowed ATV to acquire research and technology at wholesale prices that would have required years to develop independently, the approach also

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Rule 34-4.

forced ATV to inherit the management, marketing, production, and service woes that brought the companies down in the first place. In other words, ATV acquired assets that might have become valuable in the future as research and development ripened into product lines. But at the same time, ATV acquired significant current liabilities and start-up costs as operations were restructured and redirected.

Because of this business plan, ATV was a cash-hungry venture and the founders' personal resources were fast becoming inadequate to meet the company's needs. The founders first considered taking ATV public in late 1982, but because the company needed immediate financial assistance, ATV's founders sought alternate sources of cash. Help arrived in the form of a $10 million injection of funding in early 1983 from various venture capital investment groups. ATV in return issued convertible debentures.

The debenture holders were not interested in a long-term investment. The game plan was to boost ATV's respectability in the industry to the point where it could be taken public. The debenture holders would then exercise their conversion rights and sell their shares on the open market. If all went well, the venture capitalists would recoup their $10 million plus a tidy profit, ATV would be out from under the burden of the debt and positioned to pursue its aims even more aggressively, and the founders, through their stock holdings, would be rewarded accordingly.

All did not go well. As a practical matter, taking the company public was now no longer an option, but a necessity. A failure to go public would not only trigger an obligation to retire most of the debenture debt, but also would increase that debt by $2 million. In retrospect, ATV was not well-positioned to make a public offering. Nevertheless, ATV retained a prestigious securities law firm, a large accounting firm, and E.F. Hutton as lead underwriter during the spring and summer of 1983.

As originally planned, the initial public offering (IPO) was to be 2.2 million shares with a price range of $15-$18 per share. As time passed, the number of shares and the price per share declined. When the company filed the preliminary prospectus with the Securities and Exchange Commission in August 1983, it still proposed to issue 2.2 million shares, but the price had dropped to $13-$15 per share. E.F. Hutton further reduced the price to $10 and the number of shares to only 600,000. By that time, high-tech IPOs had fallen out of favor with the market and ATV's "road shows" had not generated the interest expected. Thus, instead of the $30 million ATV hoped to generate, the gross would only be $6 million. In the end, most of the 600,000 shares were sold by the debenture holders and after deducting substantial legal and accounting fees and other costs, ATV realized no net cash. In fact, Gomez drafted an internal memorandum indicating that the IPO cost ATV money. Taking the company public accomplished two things: ATV was relieved of some debenture debt, and the stage was set for this action.

The IPO was effective on October 18, 1983. Beginning in January 1984, ATV released a series of negative earnings reports and the stock reacted sharply. Far from being a growth company poised for continued expansion, as the prospectus suggested, it became clear to the market that ATV was not doing well. In the quarter in which the company went public, ATV recorded a net loss of almost $2 million. ATV would ultimately post a loss of more than $31 million for the fiscal year ending March 31, 1984. The stock was delisted by the National Association of Securities Dealers Automated Quotation Market System. ATV eventually returned to a position of modest profitability, but closed its doors in 1988.

Investors who had purchased ATV stock at $10 per share and sold it for a quarter of that amount several months later wondered if there was more to the story than unexpected

business reversals. This class action followed against Gomez, O'Connor, Gleason, E.F. Hutton, Ernst & Whinney (now Ernst & Young), the debenture holders who exercised their conversion rights, two ATV board members, and several others. Knapp asserted liability on a variety of theories, including federal racketeering and securities laws violations and numerous state-law claims.

All defendants settled pretrial, or were otherwise removed from the case, except for Gomez (ATV's chief executive officer and chairman of the board), O'Connor (ATV's executive vice-president), and Ernst & Whinney (ATV's outside auditor). At the conclusion of the evidence, the trial court dismissed the RICO and pendent state-law claims.

At Knapp's request, the case was bifurcated into a trial of class-wide issues to be followed, if necessary, by a second-stage proceeding to adjudicate individual issues of reliance and damages. After a four-week trial, the court submitted to the jury only the securities claim, based on section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder.

At trial, Knapp attempted to show that Ernst & Whinney should have included a "going concern" statement in its audited financial statements. Knapp also presented some evidence suggesting that Ernst & Whinney should have recognized the many problems within ATV and that, given these problems, it should have further investigated and distanced itself from ATV's unaudited financial statements. The jury returned a general verdict against all defendants and set forth what it found to be the "true value" of ATV stock for each trading day of the class period. In addition, the jury found the proportionate fault of the settling defendants to be zero. Thereafter, the district court denied Ernst & Whinney's motions for judgment as a matter of law or, in the alternative, for a new trial. The court also denied Knapp's motions for prejudgment interest.

After the commencement of the second-stage proceedings, Knapp submitted claims for damages from each of the class members. In motions for summary judgment, Ernst & Whinney contested the claims of some of those class members, including four institutional investors. The district court denied Ernst & Whinney's motion and granted Knapp's cross-motions for summary judgment on the claims. This opinion addresses only Ernst & Whinney's arguments. Gomez and O'Connor's contentions are resolved in a separate, unpublished decision.

II

Prior to trial, Knapp settled with various defendants, receiving a total amount that was 25 percent greater than what the jury ultimately awarded. Ernst & Whinney contends that the damages awarded at trial should be offset by the amount recovered from the settling defendants, effectively reducing the jury's award to zero. Whether plaintiffs' recovery against nonsettling defendants must be offset by pretrial recovery from settling defendants is a question of law that we review *de novo*. *See generally United Commercial Ins. Serv. v. Paymaster Corp.*, 962 F.2d 853, 856 (9th Cir.), *cert. denied*, 506 U.S. 1022, 113 S.Ct. 660, 121 L.Ed.2d 585 (1992).

In *Franklin v. Kaypro Corp.*, 884 F.2d 1222 (9th Cir. 1989) (*Kaypro*), *cert. denied*, 498 U.S. 890, 111 S.Ct. 232, 112 L.Ed.2d 192 (1990), we set out the analysis a trial court should use when determining the liability of nonsettling defendants where plaintiffs have already settled with other defendants. *Id.* at 1231. We explained as follows:

> Nonsettling defendants are [ ] barred from further rights of contribution from the settling defendants. At trial, the jury is asked not only to determine the total dollar damage amount, but also the percentage of culpability of each of the nonsettling defendants as well as that of the settling defendants. Nonsettling defendants as a whole will then be required to pay the percentage of the total

> amount for which they are responsible. The nonsettling defendants will be jointly and severally liable for that percentage, and will continue to have rights of contribution against one another.

Id. (footnote omitted). Pursuant to the rule in *Kaypro*, the district court instructed the jury to apportion fault among the settling and nonsettling defendants. The jury found the proportionate fault of the settling defendants to be zero percent. Following *Kaypro*, the district court refused to offset the jury's award because the jury found the settling defendants to be blameless.

Ernst & Whinney asks us to alter the *Kaypro* proportionate fault rule, arguing that the rule is inconsistent with 15 U.S.C. § 78bb(a) and that the rule in *Kaypro* is actually dicta. In the district court, Ernst & Whinney "recognize[d] that [the district court] is bound by" *Kaypro*. We will not consider Ernst & Whinney's arguments concerning the applicability of *Kaypro*, which are being made for the first time on appeal.

III

After the first phase of the trial, the jury effectively found that the plaintiff class was entitled to a presumption of reliance. Upon commencement of the second phase, Ernst & Whinney moved for summary judgment on the ground that it had rebutted the presumption of reliance as to certain sophisticated investors. The district court rejected Ernst & Whinney's argument and instead entered summary judgment for Knapp. We review a summary judgment *de novo*. *First Pacific Bank v. Gilleran*, 40 F.3d 1023, 1024 (9th Cir. 1994), *cert. denied*, — U.S. —, 116 S.Ct. 55, 133 L.Ed.2d 19 (1995). We must determine (1) whether there is a genuine issue of material fact when the evidence is viewed in the light most favorable to the nonmoving party, and (2) whether the district court correctly applied the law. *Id.*

In *Basic Inc. v. Levinson*, 485 U.S. 224, 247, 108 S.Ct. 978, 991-92, 99 L.Ed.2d 194 (1988), the Court held that in a securities fraud action premised on a fraud on the market, purchasers and sellers of securities in the marketplace are entitled to a presumption of reliance. The presumption of reliance is premised on a belief that, at the very least, "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices." *Id.* at 247 n.24, 108 S.Ct. at 991 n.24. Because a material misrepresentation or omission is generally embedded in the market price of the security, an investor who purchases or sells the security will have presumably relied on the misrepresentation.

A defendant may rebut the presumption of reliance in one of several ways. A defendant might "show that the 'market makers' were privy to the truth ... and [ ] that the market price would not have been affected by [ ] misrepresentations, ... [so] the basis for finding that the fraud had been transmitted through market price would be gone." *Id.* at 248, 108 S.Ct. at 992. A defendant might also show that the plaintiff was aware of the misrepresentation and purchased or sold his shares anyway. Or, a defendant might establish that had the plaintiff been aware of the misrepresentation, he still would have engaged in the same market transaction. *Id.* at 248-49, 108 S.Ct. at 992-93; *see also Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975) (*Blackie*), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976).

Ernst & Whinney argues that as to four class plaintiffs, it had effectively rebutted the presumption by showing (a) that the investors were sophisticated institutional investors, and (b) that experts testified that sophisticated investors should have been aware of the information that was omitted from Ernst & Whinney's audits, including a going concern qualification and disclosures concerning ATV's liquidity and the adequacy of collateral for an ATV loan. Ernst & Whinney relies on the following testimony from Knapp's expert witness:

> Sir, I don't believe the average person reading [the ATV prospectus] will understand the nature of the market and the uncertainties that surround a new offering and volatility of the market, [ ] the enormous potential for downturns in the market of this kind. [ ] [I]t's only people who have a substantial degree of experience and interest in the market that will understand that.

Ernst & Whinney essentially argues that because a sophisticated investor would not have been misled by ATV's financial statements, then those investors must have purchased ATV's stock knowing full well what the true value of the stock was.

Ernst & Whinney's argument proves too much. If sophisticated investors would have read the ATV financial statements in a way that rendered the omissions or misstatements immaterial, then the market price would not have been artificially inflated. Ernst & Whinney is arguing that not a single sophisticated investor could have been misled. Extending Ernst & Whinney's analysis, these investors' knowledge of the "truth" would have prevented the price from becoming artificially inflated.

This is not what the jury found, however. In the first phase of the trial, the jury found that the market price for ATV stock was inflated due to defendants' misstatements or omissions. In so finding, the jury necessarily rejected the testimony of Knapp's expert, insofar as he was testifying that sophisticated investors would not have been fooled. Ernst & Whinney does not now contend that the jury's verdict was not supported by substantial evidence, and we thus will not disturb its findings. The district court therefore properly denied Ernst & Whinney's motion for summary judgment and properly entered summary judgment for Knapp.

IV

Ernst & Whinney argues that the district court's formulation of the instruction on loss causation was erroneous. Jury instructions must be formulated so that they fairly and adequately cover the issues presented, correctly state the law, and are not misleading. *Fikes v. Cleghorn*, 47 F.3d 1011, 1013 (9th Cir. 1995). When the alleged error is in the formulation of the instructions, the instructions are to be considered as a whole and an abuse of discretion standard is applied to determine if they are misleading or inadequate. *Gizoni v. Southwest Marine Inc.*, 56 F.3d 1138, 1142 n. 5 (9th Cir.), *cert. denied*, — U.S. —, 116 S.Ct. 381, 133 L.Ed.2d 304 (1995). However, when the argument is that the trial court misstated the elements that must be proved at trial, we review *de novo*. *Id.* at 1142.

The parties characterize the nature of the alleged error differently. Ernst & Whinney argues that because the district court misstated the loss-causation element, review is *de novo*. Knapp argues that because the district court did instruct on loss causation, the question is one of formulation, and should be reviewed for an abuse of discretion. We need not resolve the issue because we arrive at the same result under either standard of review.

Ernst & Whinney makes two related arguments. First, it argues that the court's loss-causation instruction was erroneous. Second, it argues that the court should have entered a judgment as a matter of law for Ernst & Whinney as to those plaintiffs who bought and sold ATV stock before any corrective statements had been made.

We first address whether the district court's loss-causation instruction was erroneous. Knapp argues that because Ernst & Whinney failed to object to the instruction as given, it waived its ability to challenge the instruction on appeal. However, after submitting proposed jury instructions and their respective objections to the district court, the parties met

with the court at a conference held off the record. On the record, the parties stipulated that this procedure would not be cited by any party as a failure to satisfy the requirements of Federal Rule of Civil Procedure 51, which would otherwise require further objection on the record. Knapp's attempt to avoid the impact of this stipulation is baffling, and fails to persuade us that the alleged error has been waived.

The district court rejected Ernst & Whinney's proposed instruction, which would have directed the jury to find loss causation if Ernst & Whinney's "misrepresentations or misleading omissions ... were the reason for the [stock's] decline in price." Instead of using Ernst & Whinney's instruction, the district court instructed the jury to find loss causation if it found,

> that there were material misrepresentations and/or omissions which caused the market price of ATV stock purchased by the class members to be higher than it would have been if all the true facts were known or if you find that ATV's stock would not have been issued.

The district court's instruction, which focused on the reason for the plaintiffs' "alleged loss" was an accepted statement of loss causation. In a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation. *See Gray v. First Winthrop Corp.*, 82 F.3d 877, 886 (9th Cir. 1996) (loss causation present if "disclosure of the truth would have reduced the proper valuation of [the] investment" (internal quotation omitted)); *Wool v. Tandem Computers*, 818 F.2d 1433, 1437 (9th Cir.1987) (*Wool*) (focus should be on "the difference between the purchase price and the value of the stock at the date of purchase" (internal quotation omitted)). This is precisely what the court's instruction required the jury to find before imposing liability. Although there may be other acceptable formulations of this element, the court's instruction was proper.

Second, Ernst & Whinney argues that, as a matter of law, plaintiffs who both purchased and sold their stock before corrective statements had been made could not have established loss causation. Ernst & Whinney in effect argues that those who had unloaded their ATV stock before the price plummeted are unable to show that the misrepresentations caused their losses. But we have held repeatedly that price changes that occur before a corrective statement might still be the "result of market forces operating on the misrepresentation." *Wool*, 818 F.2d at 1437; *Blackie*, 524 F.2d at 909 n. 25; *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1976) (per curiam) (Sneed, J. concurring). Thus, those who trade before corrective statements are made can suffer losses caused by the misrepresentation.

For the same reason, Ernst & Whinney's focus on the post-disclosure price (which was significantly higher than the value the jury found) as the true value of the stock is also wrong. Although the post-disclosure price may in some cases be evidence of the value of the stock before disclosure, the post-disclosure price is not a measure of pre-disclosure value. *See Wool*, 818 F.2d at 1437-38 & nn. 3-4. As the district court held, "[t]he jury has already determined the stock was inflated on each day of the class period. The jury also has determined that the cause of the inflation was the material misrepresentations and omissions. [Ernst & Whinney] cannot reargue at this time ... that forces other than the deceptions caused the overvaluation."

V

Ernst & Whinney contends that the district court erred by instructing the jury on aiding and abetting liability under Rule 10b-5. After the first phase of the trial, but before a final judgment, the Supreme Court held that Rule 10b-5 does not impose liability for aiding and abetting a primary violation. *Central Bank v. First Interstate Bank*, 511 U.S. 164, —, 114 S.Ct. 1439, 1455, 128 L.Ed.2d 119 (1994). Ernst & Whinney renewed its motion for a new trial based on the Supreme

Court's intervening decision in *Central Bank*. The district court denied Ernst & Whinney's motion.

Initially, we must decide whether Ernst & Whinney properly preserved its objection to the aiding and abetting instruction. Knapp argues that Ernst & Whinney submitted an aiding and abetting instruction to the court; thus, Knapp argues, Ernst & Whinney invited the error and we cannot review it. It is true that ordinarily invited error is unreviewable. *Gilchrist v. Jim Slemons Imports*, 803 F.2d 1488, 1493 (9th Cir. 1986). However, review of invited error in an instruction may be appropriate "when the issue arises by virtue of a change in law while the appeal is pending." *United States v. Mkhsian*, 5 F.3d 1306, 1310 (9th Cir. 1993). That is exactly the circumstance before us.

This situation is analogous to our discretion to review an alleged error despite a failure to object to an instruction if a "solid wall of Circuit authority" would have rendered an objection futile. *Robinson v. Heilman*, 563 F.2d 1304, 1307 (9th Cir. 1977) (per curiam). At the time of trial, it would have been pointless for Ernst & Whinney to object to the aiding and abetting instruction. Our law was settled. *See, e.g.*, *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991) (aiding and abetting liability exists under Rule 10b-5).

Exercising our discretion to review the instruction also makes sense because the district court in fact did review the issue prior to entry of final judgment. Here, the district judge was not "blind-sided," but fully considered the question on Ernst & Whinney's motion for a new trial and made a decision that we can review. We hold that review was not foreclosed in this appeal.

The parties disagree as to the standard we should use to review the district court's denial of Ernst & Whinney's motion for a new trial. Ordinarily, we review the district court's denial of a motion for a new trial for an abuse of discretion. *Traver v. Meshriy*, 627 F.2d 934, 940-41 (9th Cir.

1980) (*Traver*) ("In determining whether to grant a new trial, the district court must decide whether, in its conscientious opinion, the verdict is clearly contrary to the weight of the evidence. On appeal, this court will not disturb a verdict unless, viewing the evidence in a manner most favorable to the prevailing party, we can say that the trial court abused its discretion." (internal citations omitted)); *Robins v. Harum*, 773 F.2d 1004, 1006 (9th Cir. 1985). However, we have also held that whether a case is submitted to the jury on incorrect legal theories is a question of law that we review *de novo*. *Counts v. Burlington Northern R.R. Co.*, 952 F.2d 1136, 1139 (9th Cir. 1991) (*Counts*). Ernst & Whinney would have us review the district court's denial *de novo*; Knapp insists that our review is for an abuse of discretion.

Here, however, we are not reviewing an issue of law. In its denial of Ernst & Whinney's motion, the district court correctly recognized that one of the theories of liability submitted to the jury was not proper. Ernst & Whinney does not challenge this aspect of the district court's decision. Rather, Ernst & Whinney is challenging the district court's decision to refuse a new trial despite the erroneous submission. This decision was entirely discretionary.

The jury rendered a general verdict and therefore did not state whether its findings were based on a primary theory of liability or a secondary theory of liability. "As a general rule, a general jury verdict will be upheld only if there is substantial evidence to support each and every theory of liability submitted to the jury." *Kern v. Levolor Lorentzen, Inc.*, 899 F.2d 772, 777 (9th Cir. 1990) (*Kern*) (internal quotation omitted). In *Traver*, however, we carved out an exception to this general rule, holding:

> Where more than one theory of recovery has been submitted to the jury in a civil case, and where on appeal it is claimed that as to one of the theories there was a lack of evidential support or an error of law in submitting the theory to the jury, the reviewing court has

> discretion to construe a general verdict as attributable to another theory if it was supported by substantial evidence and was submitted to the jury free from error.

627 F.2d at 938. This narrow exception has been the target of vigorous and persuasive criticism. *See Kern*, 899 F.2d at 789-92 (Kozinski, J., dissenting); *compare Anixter v. Home -Stake Prod.*, 77 F.3d 1215, 1229 (10th Cir. 1996) (*Anixter*) (reversing general verdict that could have been based on either primary or secondary liability under Rule 10b-5 because it could not be said "'with absolute certainty' that the jury was not influenced by the submission of the improper or erroneous instruction"). However, this exception is the law in our circuit, and the district court, which first reviewed the alleged error, had the discretion to apply the exception if it found that substantial evidence supported a primary theory of liability.

Our review of the district court's decision to apply the exception in *Traver* is limited to whether the court abused its discretion. We will not reverse this exercise of discretion unless we have "a definite and firm conviction that the court below committed a clear error of judgment in the conclusion it reached upon a weighing of the relevant factors." *Smith v. Jackson*, 84 F.3d 1213, 1221 (9th Cir. 1996) (*Smith*).

In deciding to exercise its discretion under *Traver*, the district court examined the two theories of liability—primary and secondary liability—and analyzed the following:

> (1) the potential for confusion of the jury, (2) whether the losing party's defenses apply to the count upon which the verdict is being sustained, (3) the strength of the evidence supporting the count relied upon to sustain the verdict, and (4) the extent to which the same disputed issues of fact apply to the various legal theories.

citing *Counts*, 952 F.2d at 1140; *see also Portland Feminist Women's Health Center v. Advocates for Life, Inc.*, 62 F.3d 280, 285-86 (9th Cir. 1994) (applying analysis in case where

an intervening Supreme Court decision eliminated a theory of liability that had been submitted to the jury). It is undisputed that the district court applied the *Traver* analysis. Thus, the district court's decision was based "upon a weighing of the relevant factors." *Smith*, 84 F.3d at 1221. The remaining question is whether the district court "committed a clear error of judgment" in deciding that although an aiding and abetting theory of liability could not support the jury's general verdict, sufficient evidence of primary liability under Rule 10b-5 supported the verdict. *See id.*

In focusing on the possible jury confusion, the district court reasoned that Knapp did not emphasize a theory of secondary liability, and focused on Ernst & Whinney's failure to include a going concern qualification. The district court, after reviewing the record, stated that it was "unlikely that the jury found the defendant liable on a secondary theory of liability."

Ernst & Whinney disputes the district court's view of Knapp's evidentiary focus. Ernst & Whinney argues that each expert spent some time, and some experts spent the majority of time, providing evidence that supported secondary liability. Therefore, Ernst & Whinney insists that, because a larger percentage of time was spent examining experts about ATV's unaudited financial statements, the district court "clearly erred" in deciding that Knapp's focus was on a primary theory of liability. Even if Ernst & Whinney's comparative transcript-page count is accurate, a review of the entire transcript supports the district court's position that the parties emphasized Ernst & Whinney's failure to include a going concern qualification. For example, Knapp's accounting and auditing expert spent a significant portion of her testimony explaining why Ernst & Whinney should have included a going concern qualification. As the district court explained, Knapp's closing argument emphasized the lack of the going concern qualification, and mentioned Ernst & Whinney's association with the financial statements as a

separate issue. This separation of issues supports the district court's determination that the jury was unlikely to be confused. Thus, the record supports the district court's decision that the potential for jury confusion was minimal.

The district court next determined that Ernst & Whinney's defenses applied essentially equally to both theories of liability. Ernst & Whinney does not dispute this, but instead asserts that its defenses "most certainly would not have been the same if there had been no claim for aiding and abetting." We do not doubt that Ernst & Whinney's trial strategy would have been different absent an aiding and abetting theory of liability. However, *Traver* instructed the district court to consider only "whether privileges or defenses of the losing party apply to the count upon which the verdict is being sustained so that they would have been considered by the jury with reference to the count." *Traver*, 627 F.2d at 938-39. The district court properly considered this part of the *Traver* analysis.

The district court next discussed the strength of the evidence supporting the primary liability theory. The court determined the evidence was substantial, referring specifically to:

> (1) the mix of information contained in the prospectus and its included financials materially misstated the company's current economic posture and known future prospectus, (2) the defendant either subjectively knew of the misstatements or was willfully blind to them, and (3) the defendant was motivated by the desire to garner substantial fees. The court also found the evidence was sufficient to convince a reasonable jury that the defendant was aware the scaled back offering would dramatically impact ATV's liquidity. Nevertheless, the defendant failed to include a going concern qualification.

We do not fault the court's application of the third part of the *Traver* analysis.

Finally, the district court decided that underlying both theories of liability were similar issues of fact. "The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff." *Anixter*, 77 F.3d at 1225. Here, the primary issues of fact were whether the statements made within ATV's financial statements were deceptive and whether Ernst & Whinney acted with scienter. The district court correctly determined that there is sufficient applicability of these two issues to both theories of liability.

Therefore, because the district court properly weighed each of the *Traver* considerations, the court did not abuse its discretion in applying the exception and upholding the general verdict.

VI

After the jury returned its verdict, Knapp moved for prejudgment interest, calculated at the rate prevailing during the class period. Knapp cross-appeals, challenging the district court's denial of this request. We review the district court's decision for an abuse of discretion. *Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984). However, the required demonstration of a clear error of judgment is phrased somewhat differently when reviewing the issue of prejudgment interest. "The court's decision ... [is to be] upset only if it is so unfair or inequitable as to require it." *Id.* "Whether interest will be awarded is a question of fairness, lying within the [trial] court's sound discretion, to be answered by balancing the equities." *Wessel v. Buhler*, 437 F.2d 279, 284 (9th Cir. 1971).

Before denying Knapp prejudgment interest, the district court considered the facts and provided several bases for its decision. First, the district court stated that awarding Knapp prejudgment interest was improperly speculative. The district court correctly stated that prejudgment interest serves a

compensatory function, designed to make the injured party whole. *Frank Music Corp. v. Metro-Goldwyn-Mayer, Inc.*, 886 F.2d 1545, 1550 (9th Cir. 1989), *cert. denied*, 494 U.S. 1017, 110 S.Ct. 1321, 108 L.Ed.2d 496 (1990). The district court also correctly recognized that speculative damages are generally not awarded. *Lindy Pen Co. v. Bic Pen Corp.*, 982 F.2d 1400, 1407-08 (9th Cir.), *cert. denied*, 510 U.S. 815, 114 S.Ct. 64, 126 L.Ed.2d 34 (1993). It concluded that the speculative nature of prejudgment interest in this case cut against allowing an award.

As the district court rightly explained, ATV was an exceptionally speculative investment. Furthermore, as the district court stated, "[h]ad the class members not purchased ATV stock, they may have invested in something else with the expectation of gaining a profit." The district court pointed out that "it is speculative to conclude that other investments would have been profitable," and that, therefore, prejudgment interest was also impermissibly speculative.

We have doubts about this reasoning. If, as the district court postulated, this same class of plaintiffs had invested in a basket of securities as risky as ATV, the class as a whole would expect to receive from their investments a rate of return higher than the risk-free rate prevailing during the class period. Thus, awarding Knapp interest based on the prevailing risk-free rate would not necessarily have been impermissibly speculative. *See, e.g., Western Pacific Fisheries v. S.S. President Grant*, 730 F.2d 1280, 1289 (9th Cir. 1984) (using risk-free 52-Week Treasury Bill rate).

The district court's second reason was an unwillingness to award prejudgment interest because "[t]he record is devoid of any support for the premise that the case involved evil intent or premeditated fraud by any defendant." The defendants' degree of culpability was permissible for the district court to consider. *See Osterneck v. Ernst & Whinney*, 489 U.S. 169, 176, 109 S.Ct. 987, 991, 103 L.Ed.2d 146 (1989) (court may consider, among other things, "the degree of

personal wrongdoing on the part of the defendant"). Furthermore, the district court's findings as to the defendants' extent of culpability were not clearly erroneous. Although each defendant's state of mind may have triggered liability under Rule 10b-5, the district court's analysis was consistent with the jury's findings. The district court did not find that the defendants lacked scienter. Rather, it found that the evidence pointed to a state of mind less than a malicious intent to defraud investors. The record contains ample support for the finding.

Finally, the district court also properly considered whether prejudgment interest would amount to a windfall recovery for Knapp. *See id.* (court may consider "whether prejudgment interest is necessary to compensate the plaintiff fully for his injuries"). The district court held that because Knapp received an amount from settling defendants that was even greater than the jury's verdict, prejudgment interest was not necessary for full compensation to Knapp. The district court's finding was not clearly erroneous.

Overall, the district court balanced the equities and determined that prejudgment interest was not in the interest of justice. Although we have doubts about the district court's argument that prejudgment interest would be overly speculative, its overall balance was not an abuse of discretion. The district court properly considered two issues and its overall analysis did not indicate its discretion was abused.

Because we affirm the jury's verdict, we need not consider Knapp's request to reinstate dismissed pendant state-law claims.

AFFIRMED.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

Civ. No. 87-0067-H(M)

STANLEY KNAPP, On Behalf of Himself and All Others Similarly Situated,

Plaintiff,

vs.

PHILLIP J. GOMEZ, et al.,

Defendants.

JUDGMENT

The issues common to all class members in this action came on for trial before a jury and the court, the Honorable Robert J. McNichols, District Judge, presiding. Those issues were tried and the jury rendered its verdict in favor of the plaintiff class and against defendants Philip J. Gomez, Douglas O'Connor and Ernst & Whinney on February 10, 1992. Individual issues of reliance and damages were decided by this court on motions for salary judgment as set forth in orders of this court, dated December 16, 1993, February 10, 1994 and July 14, 1994. It is now Ordered and Adjudged as follows:

That judgment be entered against defendants Philip J. Gomez, Douglas O'Connor and Ernst & Whinney and in

favor of the plaintiff class in the total amount of $1,587,947.00 with interest thereon pursuant to 28 U.S.C. §1961 and costs of suit in the amount of $_____.

Dated at San Diego, California, this 6th day of Sept., 1994.

HONORABLE MARILYN L. HUFF
UNITED STATES DISTRICT JUDGE

APPENDIX C

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

Case No. CV 87-0067 H

STANLEY KNAPP, On Behalf of Himself and All Others Similarly Situated,

Plaintiff,

vs.

PHILLIP J. GOMEZ, et al.,

Defendants.

ORDER (1) GRANTING PLAINTIFFS' MOTION FOR RECONSIDERATION OF DISALLOWANCE OF LATE CLAIMS, (2) DENYING PLAINTIFFS' MOTION FOR TRIAL ON PHANTOM ADDITIONAL DAMAGES, (3) GRANTING PLAINTIFFS' SUMMARY JUDGMENT MOTION AND DENYING DEFENDANT'S MOTION FOR SUMMARY JUDGMENT ON REMAINING CLAIMS, AND (4) DENYING DEFENDANT'S MOTION FOR A NEW TRIAL

[filed July 14, 1994]

INTRODUCTION

On June 13, 1994, this court held a hearing on the plaintiffs' motion for reconsideration of the court's disallowance of late claims, (2) the plaintiffs' motion for a trial on damages, (3) the plaintiffs' and defendant Ernst & Whinney's summary judgment motions on the remaining claims, and (4) defendant Ernst & Whinney's motion for a new trial. Dennis Stewart and Theodore Pintar appeared on behalf of the plaintiffs, Peter Benzian and Daniel Gray appeared on behalf of defendant Ernst & Whinney, and Philip Gomez appeared

in pro per. At the hearing, the court requested the parties submit supplemental briefing on the defendant's motion for a new trial. The court informed the parties that, after receiving the briefing, the court would issue an order resolving these remaining issues. The parties have now provided the court with the supplemental briefing requested.

After considering the extensive oral argument and briefing, the court grants the plaintiffs' motion for reconsideration of the court's prior disallowance of the late submitted claims, denies the plaintiffs' request for a trial on phantom additional damages, grants the plaintiffs' summary judgment motion and denies the defendant's summary judgment motion, and denies the defendant's motion for a new trial.

With regard to the plaintiffs' motion for reconsideration, the plaintiffs rely on the recent Ninth Circuit case of *Silber v. Mabon*, 18 F.3d 1449 (9th Cir. 1994). Because the court finds the case to be en pointe and the plaintiffs have presented good cause for the late submission, the court grants the motion.

The court, however, denies the plaintiffs' request for a trial on phantom additional damages. The court finds the request to be untimely and finds no issues remain to be litigated with regard to damages. The only reason for a new trial would be to increase the amount of attorney's fees available to the plaintiffs' counsel to the detriment of the claiming plaintiff class.

The court next grants the plaintiffs' summary judgment motion on the Stanley, Wellnik, and Baer claims. The court finds the defendants have not rebutted the presumption of reliance simply by arguing these investors were sophisticated and, therefore, should have been aware of the deceptions. The court also denies the defendant's request for a new trial, based on the recent case of *Central Bank v. First Interstate*, 114 S.Ct. 1439 (1994). As previously found, the court finds

substantial evidence supports a verdict on a theory of primary liability and the court finds it unlikely the jury was confused.

Finally, as detailed below, the court requests the parties provide the court with the total amount of judgment to be entered in this action without aggregate damages and provide the court with the sum total of attorney's fees and expenses. After the court receives the supplemental information, the court will issue a final judgment terminating the action at this level.

BACKGROUND

In 1987, the plaintiffs brought this action under section 10(b) of the Securities Exchange Act. In November 1987, the court certified the class. The plaintiffs alleged the defendants made various material misrepresentations and omissions in connection with an initial public offering of ATV Systems stock.

In 1981, Philip Gomez, Douglas O'Connor, and Frank Gleason founded ATV. The company decided to go public in order to raise funds. The initial public offering was originally to consist of 2.2 million shares, with a price range of $15 to $18 per share. The ultimate offering, however, consisted of only 600,000 shares, with a reduced price of $10 per share. In addition, by the time of the offering, the market had dropped for the high-tech public offerings. Thus, instead of the $30 million ATV hoped to generate from the offering, the gross revenue would be only $6 million.

The offering was effective on October 18, 1983. In January 1984, ATV began releasing a series of negative earnings reports, to which the market reacted. For the fiscal year ending March 31, 1984, ATV reported a loss of more than $31 million. NASDAQ delisted the stock and the company eventually closed in 1988.

Prior to trial, the plaintiffs settled with most of the defendants. The case proceeded to trial against Ernst &

Whinney, Gomez, and O'Connor. The trial judge granted the plaintiffs' motion to bifurcate the trial. The issues presented to the jury in the first phase were: (1) did the defendants make a material misrepresentation or omission, (2) did the defendants act with scienter, (3) did the misrepresentation or omission cause an artificial inflation in the price of the ATV stock, (4) are the class of purchasers entitled to a presumption of reliance, and (5) what was the true value of the ATV stock during the class period. The jury returned a verdict in favor of the plaintiff class.

After the trial, the following individual issues remained: (1) have the defendants rebutted the presumption of reliance, (2) the appropriate calculation of damages suffered by the individual class members, and (3) the appropriate award of attorney's fees and costs. Prior to resolution of these issues, the trial judge died and the case was reassigned to this court on January 8, 1993. Since that time, the court has heard numerous post-trial motions. The parties now move for resolution of the remaining issues.

DISCUSSION

The parties bring several motions. First, the plaintiffs request this court reconsider the prior order precluding the submission of late claims. Second, the plaintiffs request a trial on phantom damages. Next, both parties move for summary judgment on the remaining claims in which this court permitted further discovery. Finally, the defendant moves the court for a new trial, relying on recent Supreme Court precedent.

A. PLAINTIFFS' REQUEST FOR RECONSIDERATION OF ORDER REGARDING LATE CLAIMS

On February 10, 1994, the court denied the plaintiffs' request to submit two late claims. The court found the notice provided gave the class members an adequate opportunity to submit their claims and a final bar date was necessary to bring this litigation to a close. The plaintiffs move for

reconsideration of this order, relying on the recent Ninth Circuit case of *Silber v. Mabon*, 18 F.3d 1449 (9th Cir. 1994).

In *Silber*, a class member did not receive the opt-out notice until after the deadline to opt out. The class member attempted to opt out, but the district court refused to permit the member to opt out after the deadline. The district court found the member should have seen the notice published in the newspaper and the court believed a firm date was necessary to bring the action to a close. The Ninth Circuit concluded the district court's reasoning was insufficient as a matter of law. Specifically, the Ninth Circuit concluded the court cannot rely solely on publication for notification, and the defendant's interest in finality would not be affected because, at the time the member sought permission to opt out, a final judgment had not been entered. The Ninth Circuit remanded the action to the district court for a determination of whether good cause excused the late request. The factors the Ninth Circuit concluded were relevant to this determination focused on the cause of the delay in receiving the notice, whether the member was at fault for the late request, how quickly the member responded after receiving actual notice, and the effect the request would have on a settlement or the finality of a judgment.

The court finds this case to be en pointe and also finds good cause excuses the submission of late claims by Jacqueline Cuda-Kersten and Sterling Tremayne. On November 27, 1991, a notice of pretrial settlement was sent to class members informing them of the settlement fund. On June 2, 1993, a notice of verdict was approved by the court and sent to class members. This notice informed the members they must submit their proof of claim by September 15, 1993, in order to participate in the recovery.

Cuda-Kersten has submitted a declaration stating that she did not receive the proof of claim form until December 3, 1993. Upon receiving the form, she immediately called

Gilardi & Co., the claims administrator. She was not able to speak with anyone until December 6, 1993. On that same date, she signed the claim form and submitted the form with supporting documentation. She also stated that, prior to receiving the form, she had not received any notice regarding the action and was unaware litigation involving ATV was ongoing.

Similarly, Tremayne has submitted a declaration, in which he states, in mid-December 1993 a friend told him about the ATV litigation. He contacted Gilardi & Co. three days later to acquire a claim form. After receiving the claim form, he completed and submitted the form to Gilardi & Co. on December 21, 1993. Prior to receiving the information from his friend and Gilardi & Co., Tremayne stated he had no notice of the ongoing ATV litigation.

The court finds good cause supports the late submission of the claims. Neither claimant is at fault for responding late. Neither claimant had notice of the action or the need to file a claim form until after the deadline had passed. However, upon learning of the need to submit a form, both claimants acted promptly, within days. Finally, at the time the court denied the request for submission of late claims, the submission of the claims would not have significantly affected the finality of a judgment or a settlement. The court, therefore, grants the plaintiffs' request for reconsideration.

Cuda-Kersten has submitted a claim form indicating she purchased ATV stock on October 21, 1983, for a total of $5269, and on February 23, 1984, for a total of $989. Tremayne has submitted a claim form indicating he purchased ATV stock on October 18, 1983, for a total of $2,000. Both have submitted documentation supporting their purchases. The plaintiffs shall submit to the court the amount of their damages by July 20, 1994. If the defendants object to the amount, the defendants shall submit opposition to the court by July 27, 1994. The court will then issue an order specifying the amount of their damages.

B. PLAINTIFFS' REQUEST FOR A TRIAL ON DAMAGES

The plaintiffs next belatedly request a trial to determine the phantom "aggregate" damages. The plaintiffs assert a trial is necessary "in order to assess plaintiffs' counsel's fees and costs against both the claiming and nonclaiming members of the class . . . ." The sole purpose for this trial would be to increase plaintiffs' counsel's share of the attorney's fees award and to decrease the available funds for the claiming class members. At oral argument, counsel for the plaintiffs conceded they requested the trial only to preserve the issue for appeal. The court finds the request to be untimely and an additional trial to be unnecessary and against the interests of the claiming class members. Accordingly, the court denies the request.

This action was filed over seven years ago, on January 20, 1987. The action was transferred to this court on June 7, 1991. On September 23, 1991, the court set the action for trial for January 7, 1992. A jury trial began before Judge Robert J. McNichols on January 7, 1992. The trial ended on February 10, 1992, and the jury returned a verdict in favor of the plaintiffs on the same day. During trial, the plaintiffs, for strategic purposes, moved to bifurcate the trial. The plaintiffs sought to prohibit the questioning of the class representative as to whether he had read the prospectus or performed any other independent investigation on the ATV initial public offering. Judge McNichols granted the plaintiffs' motion for bifurcation.

After the return of the verdict, Judge McNichols died and the case was reassigned to this court on January 8, 1993. On January 5, 1993, the court set for hearing numerous post-trial motions, including the defendants' motion for a new trial or for entry of judgment, the plaintiffs' motion for entry of judgment, and the plaintiffs' motion for an award of prejudgment interest, motions which were pending at the time of Judge McNichols' death. The court set these motions for

hearing on January 8, 1993, but the motions were subsequently continued to permit supplemental briefing. The court also was required to review the entire trial transcript.

After extensive briefing, on May 6, 1993, the court denied the plaintiffs' and defendant's motions for judgment and denied the defendant's motion for a new trial. When the court denied entry of judgment, the court specified the plaintiffs' strategic motion to bifurcate the class issues from the individual issues was a factor in the court's ruling. Consequently, the plaintiffs were on notice the court declined to enter a piecemeal judgment as of May 6, 1993. On May 21, 1993, the court began to address the attorney's fees issue. On this date, the court set a hearing date to address the attorney's fees issue for October 4, 1993. The plaintiffs filed their application for fees and expenses on August 20, 1993. Pursuant to the court's order of September 10, 1993, the plaintiffs submitted supplemental briefing on September 22, 1993. The issue was continued and the plaintiffs filed additional supplemental briefing on December 6, 1993. The court issued an order on December 9, 1993, scheduling a hearing on the attorney's fees issue for January 24, 1994. The court also held a telephonic status conference on the fees issue on December 21, 1993. The plaintiffs filed extensive documentation supporting their fees and expenses request on January 13, 1994. Due to further disputes on the fees and expenses request, the court again continued the hearing to February 7, 1994. The court continued the hearing three additional times, in order for the plaintiffs to present further support for their request and to give the defendants an opportunity to respond. Finally, during a hearing on March 21, 1994, the court granted the request for attorney's fees and expenses.

Thus, the court has been addressing the fees and expenses issues for over one year. The plaintiffs, however, have waited until recently to raise the issue of a trial on phantom damages. As the parties were made aware, the court intended this hearing to be the last hearing in the action and to resolve

all remaining issues. Further, if the court granted the request for a trial, the court would have to duplicate its efforts in resolving the attorneys' fees issue, and the significant effort expended on resolving the attorneys' fees issue will be rendered irrelevant. The court has issued a sixteen-page order addressing only the issue of attorneys' fees. If the plaintiffs desired a trial on this issue, the plaintiffs should have timely requested one after the court denied their request for entry of judgment on May 6, 1993. Notice also has already been sent to the class members and an additional trial probably would require additional notice. Because the common fund doctrine is equitable in nature, laches may apply to bar a request for an additional trial. *Apache Survival Coalition v. United States*, 21 F.3d 895, 905 n.12 (9th Cir. 1993). The court finds the plaintiffs' request to be untimely and against the claiming class members' interests. Accordingly, the court denies the request.

Further and in the alternative, there is no need for a trial on the phantom aggregate damages to determine the appropriate amount of fees. On March 23, 1994, the court determined the appropriate amount of the common fund and the award of fees. The court found the common fund to consist of the pretrial settlement fund and the total claims asserted, resulting in a total of approximately $3,645,046. The court then applied the benchmark of 25% to the fund to award attorney's fees. The fees and expenses amounted to approximately $1,964,718.99 and constituted approximately 54% of the common fund. The court also permitted the immediate distribution of a portion of the award so that counsel could immediately be compensated.

The plaintiffs argue a trial is necessary so that the fees will be assessed against both claiming and nonclaiming members' claims, pursuant to *Boeing v. Van Gemert*, 100 S.Ct. 745 (1980). Again, the court finds *Boeing* is not applicable to the unique circumstances of this case. In *Boeing*, it was undisputed that the defendant was found liable

for a sum certain. Thus, permitting fees to be assessed against the unclaimed portion of the fund did not impermissibly shift the fees to the losing party, but instead merely permitted counsel to share in the common fund.

In this action, the court found the common fund to be approximately $3,645,046. The only purpose behind permitting an additional trial would be to increase the plaintiffs' counsel's attorney's fees. This would result in an impermissible shift of fees to the losing party, contrary to Ninth Circuit precedent. *See Paul, Johnson v. Graulty*, 886 F.2d 268, 271 (9th Cir. 1989). An increased fund, attributable to nonclaiming members, also would be fictitious and speculative. As argued by the defendant, the increased amount would represent nothing more than the opinion of the plaintiffs' expert as to the volume of trading in ATV stock and would have no bearing on the amount of the defendant's liability: the actual losses suffered by individual class members as a result of their reliance on ATV disclosure documents. On March 23, 1994, the court found this alleged fund or amount to be merely a phantom fund and not a benefit conferred upon the class members.

If the plaintiffs believe the fee award is not equitable, the plaintiffs could have pursued a lodestar approach. On two occasions, the court has invited the plaintiffs to submit documentation in support of a lodestar calculation. The plaintiffs, however, have not submitted documentation or otherwise pursued this approach. Accordingly, the court denies the plaintiffs' request for an additional trial.

Finally, as previously expressed, the court is not entirely comfortable with awarding over fifty percent of the common fund to the plaintiffs' counsel. The court also is concerned with using a gross rather than a net approach to determine the amount of fees. The court previously awarded counsel the benchmark of twenty-five percent. *See Six Mexican Workers v. Arizona Citrus Growers*, 904 F.2d 1301, 1311 (9th Cir. 1990). If the court held an additional trial, the expenses and

fees would increase, resulting in a decreased recovery to the injured class members. For example, an additional trial would result in increased expert witness fees on damages, which likely would constitute a substantial sum.[1] Thus, an additional trial would serve only to increase fees at the expense of the class members. The deadline for the submission of claim forms has already passed. If the court granted an additional trial, the court would not use the benchmark of twenty-five percent. The court would use a significantly lower percentage or the lodestar approach in order to provide adequate compensation to the class members, while at the same time, permitting an adequate fee.

The court must consider the equities and circumstances in determining the appropriate amount of the fee award. *State of Florida v. Dunne*, 915 F.2d 542, 545 (9th Cir. 1990). The Ninth Circuit has stated that courts should adjust awards if counsel would receive an unacceptably high portion of the common fund. *Id.* at 546. The court must consider whether "the combined effect of granting the fee applications in toto would be to reduce substantially the size of the common fund available for distribution to the plaintiff class." *Id.*

The court finds an additional trial would be detrimental to the class members. The court also finds the request to be untimely and a further trial is not needed to resolve any remaining issues. Accordingly, the court denies the request.

C. PARTIES' MOTION FOR SUMMARY JUDGMENT

On December 16, 1993, the court granted defendant Ernst & Whinney's request to conduct additional discovery on the nine remaining claims. The parties conducted additional

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[1] Plaintiff's damage expert, John Torkelsen, the president of Princeton Venture Research, has already claimed $308.532.75 in expert fees.

discovery by way of interrogatories. The plaintiffs now move for summary judgment on eight of those claims: Edgar Benveniste, Charles Tiano, Nessim Tiano, Julius Baer Trust Management Ltd., Spring Lake Park Fire Relief Association, Charles Stanley & Co., Richfield Fire Relief Association, and Wellnik & Co. The defendant disputes only the claims of Stanley, Wellnik, and Baer Trust. The defendant moves for summary judgment on these three claims and opposes the plaintiffs' summary judgment order. The defendant also moves to dismiss the claim of Stanley, arguing Stanley may not file a claim on behalf of its clients.

To succeed on a motion for summary judgment, the movant must first demonstrate "there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. Pro. 56(c). A genuine dispute will exist if the facts indicate "a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby*, 106 S.Ct. 2505, 2510 (1986).

If the movant meets this initial burden, the nonmovant then has the burden to demonstrate summary judgment is not appropriate. *Celotex Corp. v. Catrett*, 106 S. Ct. 2548, 2553 (1986). To make such a showing, the nonmovant must go beyond the pleadings to designate specific facts showing a genuine issue for trial. *Id.*

The court permitted additional discovery on these claims to allow the defendant an opportunity to rebut the presumption of reliance. The defendant may rebut the presumption in any manner which "severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." *Basic v. Levinson*, 108 S.Ct. 978, 992 (1988). The defendant may sever the link in at least two ways. *Blackie*, 524 F.2d at 906. The defendant may produce evidence that "an individual plaintiff purchased despite knowledge of the falsity of a representation" or that an individual plaintiff would have

purchased the security even if the plaintiff had knowledge of the falsity. *Id.*

In each of the claimants' claim forms, the claimants stated, under penalty of perjury, they would not have purchased the ATV stock at the price they paid had they known of the material misrepresentations and omissions. Because the three claimants are "sophisticated investors," the defendant argues the claimants must have been aware of the deceptions, but nevertheless purchased the securities. As the court has previously stated, sophisticated investors can take advantage of the presumption of reliance to the same extent as other investors. *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 506 (9th Cir. 1992). The Ninth Circuit has specifically held:

> Differences in sophistication . . . among purchasers have no bearing in the impersonal market fraud context because dissemination of false information necessarily translates through market mechanisms into price inflation which harms each purchaser identically. . . . Sophisticated investors are as entitled to rely on the fraud-on-the-market theory as anyone else.

Hanon v. Dataproducts Corp., 976 F.2d 497, 506 (9th Cir. 1992).

The defendant has not presented the court with any facts supporting the assertion that the three claimants were aware of the risk. The defendant merely speculates they were aware of the risk based on their sophistication and experience in investing. If the court found the defendant rebutted the presumption based on this argument, the presumption would be rendered meaningless. The court, therefore, finds the defendant has not raised a genuine issue as to whether the presumption has been rebutted. Accordingly, the court grants the plaintiffs' summary judgment motion on the eight remaining claims.

The court also rejects the defendant's argument that Stanley may not proceed on behalf of its clients. Stanley had authorization to buy and sell securities under the eleven discretionary accounts. Thus, Stanley and not the individual beneficial owners made the decision to purchase the ATV stock. More importantly, Stanley is authorized to pursue the claims on behalf of the clients and then to allocate the proceeds to the respective discretionary accounts. The defendant has demonstrated no prejudice resulting from Stanley pursuing the claims on behalf of the clients. Thus, the court will not require the eleven individuals to submit claims. The court finds this procedure would merely result in delay and unnecessary expenditure.

At the last hearing, however, the court did require Stanley to submit a declaration stating that, once recovered, the funds will be distributed to the appropriate accounts. The plaintiffs have provided this documentation. The court, therefore, rejects the defendant's argument.

The plaintiffs shall provide the court with documentation supporting the purchases for the eight claimants and shall provide the court with the amount of their damages by July 20, 1994. If the defendants object to the supporting documentation or the amount of damages, the defendants shall provide opposition papers to the court by July 27, 1994.

D. DEFENDANT'S REQUEST FOR A NEW TRIAL

Defendant Ernst & Whinney moves the court for a new trial based on the recent Supreme court case of *Central Bank v. First Interstate*, 114 S. Ct. 1439 (1994). In *Central Bank*, the Court concluded "a private plaintiff may not maintain an aiding and abetting suit under section 10(b)." *Id.* at 1455. The Supreme Court, however, noted that this rule does not relieve secondary actors of primary liability under the securities acts. The Court concluded,

> Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a

> material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under rule 10b-5 are met.

Id. Section 10(b), however, does not impose liability for "giving aid to a person who commits a manipulative or deceptive act." *Id.* at 1448.

In *Central Bank*, the Bank served as indenture trustee for the issuance of bonds by a public authority. The bonds were secured by landowner assessment liens, and bond covenants required the land subject to the liens to be worth at least 160% of the bonds' outstanding principal and interest. The covenants required an entity to provide the Bank with reports containing evidence the 160% requirement was met.

In 1988, the underwriter alerted the Bank that the report stating the 160% requirement was met may be too optimistic. The Bank delayed an independent appraisal of the property. Before the independent review was completed, the public authority defaulted on certain bonds. The bondholders then sued the Bank under section 10(b). Because the respondents had conceded the Bank's liability was premised solely upon a secondary theory of liability, the Supreme Court held the Bank was not liable to the respondents. The defendant now moves the court for a new trial based on this recent case.

The court first finds the request for a new trial to be timely. Pursuant to Federal Rule of Civil Procedure 59(b), a party must make the request within ten days after entry of judgment. The court has yet to enter judgment.

The plaintiffs argue the defendant may not take advantage of the new rule because Ernst & Whinney did not object to the instructions on aiding and abetting. Specifically, the defendant did not argue a claim for aiding and abetting is nonexistent under section 10(b).

To determine whether the defendant waived its objection, the court must address whether the defendant complied with Federal Rule of Civil Procedure 51. Rule 51 provides:

> At the close of the evidence or at such earlier time during the trial as the court reasonably directs, any party may file written requests that the court instruct the jury on the law as set forth in the requests. . . . No party may assign as error the giving or the failure to give an instruction unless that party objects thereto before the jury retires to consider its verdict, stating distinctly the matter objected to and the grounds of the objection. . . .

The purpose of Rule 51 is to enable the district court to "avoid error by affording an opportunity to correct statements and avoid omissions in the charge before the cause has been decided by the jury." *Investment Svc. v. Allied Equities*, 519 F.2d 508, 510 (9th Cir. 1975). The Rule does not require formal objections, but the party must, in some manner, make the grounds of the objection clear. *Id.*; *Brown v. Avemco Inv.*, 603 F.2d 1367, 1370 (9th Cir. 1979). The Supreme Court has explained,

> In fairness to the trial court and to the parties, objections to a charge must be sufficiently specific to bring into focus the precise nature of the alleged error. Where a party might have obtained the correct charge by specifically calling the attention of the trial court to the error and where part of the charge was correct, he may not through a general exception obtain a new trial.

Palmer v. Hoffman, 318 U.S. 109, 119 (1943). If after making the objection clear, a further objection would clearly and plainly be futile, the party need not make a further objection. *Robinson v. Heilman*, 563 F.2d 1304, 1307 (9th Cir. 1977).

The parties concede the defendant did not raise the specific objection that a private plaintiff may not pursue an aiding and abetting claim under section 10(b). The defendant

raised the following three objections to the proposed instruction on aiding and abetting: (1) whether a person charged with aiding and abetting must have actual knowledge of the primary violation, (2) whether a defendant must have known that it was substantially assisting the violation, and (3) whether a defendant's silence or inaction is sufficient to satisfy the substantial assistance element of aiding and abetting.

Under a literal reading of Rule 51, the defendant would be precluded from raising the issue because the defendant did not alert the trial court to its specific objection. *See Robinson*, 563 F.2d at 1307. Thus, the court could find the defendant is precluded from raising an objection after the jury has been charged and has rendered a verdict. Raising the specific objection may not have been futile. Ninth Circuit authority had questioned the continuing validity of a private claim for aiding and abetting under section 10(b). *Little v. Valley Nat'l Bank*, 650 F.2d 218, 220 n.3 (9th Cir. 1981); *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982).

Most importantly, had the defendant raised the objection, the trial judge could have presented the jury with special interrogatories or a special verdict which would clarify whether the jury found the defendant liable on a primary or secondary theory of liability. The defendant, however, not only did not object to the giving of an aiding and abetting instruction, but also submitted its own instruction on aiding and abetting. Thus, raising the objection would have made unnecessary a new trial and extensive post-trial briefing on the request for a new trial. The defendant also did not raise an objection that no aiding and abetting claim existed in its summary judgment motion, its memorandum of contentions of fact and law, its motions in limine, the pretrial order, or in its motion for judgment at the close of the plaintiff's case.

Further, the defendant did in fact raise other objections that may be deemed futile. For instance, the defendant

challenged the constitutionality of the civil RICO claim. The court, therefore, could decline to review the defendant's objection based on its failure to specifically object to the instruction on the grounds that no aiding and abetting claim existed under the circumstances.

The court, however, is not convinced the defendant has waived the objection. In the cases cited by the plaintiff, in support of its argument the defendant has waived an objection, the waiver related to a single element of a claim or to amplification of a term in the instructions. In *Investment Svc. v. Allied Equities*, 519 F.2d 508 (9th Cir. 1975), the party failed to object to the court's failure to amplify the definition of the reasonably prudent person standard. In *Wellman v. Jellison*, 593 F.2d 876 (9th Cir. 1979), the party failed to object to the term "successful" in an instruction defining liability. In *Robinson v. Heilman*, 563 F.2d 1304 (9th Cir. 1977), the objection related to the requisite state of mind for liability. Finally, in *Brown v. Avemco*, 603 F.2d 1367 (9th Cir. 1979), the error related to a single element of the claim. None of these cases involved an instruction erroneously informing the jury they could find liability on a particular claim. The cases do not involve an instruction erroneously instructing the jury on the entire basis for liability. The error asserted by the defendant is not limited to a single element or term, but relates to the entire claim. Thus, the court could find the cases cited to be distinguishable.

Further, if the court declined to apply the ruling in *Central Bank*, the court would deny the effect of the intervening decision, contrary to the rule that federal courts must take into account new rules of law when the action is still pending. *Robinson*, 563 F.2d at 1307.

Also, by requiring an objection under these circumstances, the court could be encouraging numerous and/or pointless objections. Federal Rule of Civil Procedure 46 provides that pointless formal objections are unnecessary. *Brown*, 603 F.2d at 1370. If the court required such an objection, the

result may be burdensome and unnecessary objections. The Ninth Circuit has recognized,

> [W]ere we to insist that an exception be taken to save the point for appeal, the unhappy result would be that we would encourage defense counsel to burden district courts with repeated assaults on the then settled principles out of hope that those principles will be later overturned.

Robinson, 563 F.2d at 1307 (quoting *United States v. Scott*, 425 F.2d 55, 57-58 (9th Cir. 1970)).

Finally, even in instances in which the Ninth Circuit has found a party has failed to comply with Rule 51, the Ninth Circuit has reviewed a party's objection when "justice requires review." *Brown*, 603 F.2d at 1375; *see also Robinson*, 563 F.2d at 1307. In *Brown*, the Ninth Circuit reviewed the objection even though the party had waived the objection under Rule 51 because the court found the issue to be "central" to the trial and equity required review. *Brown*, 603 F.2d at 1375. In *Robinson*, the court also reviewed the objection because an intervening decision significantly changed Ninth Circuit case law. *Robinson*, 563 F.2d at 1307.

In the present case, the court finds equity requires review. The issue of secondary liability certainly is central to the case. Two theories of liability were presented to the jury. Now, with the guidance of *Central Bank*, it is clear one of those theories should not have been presented to the jury. The defendant is subject to a significant sum in liability and the court finds review is necessary to ensure the jury did not impose liability on the defendant under an erroneous claim. Thus, even if the defendant did not comply with Rule 51, review of its objection is not precluded.

The trial court erroneously instructed the jury they could find the defendant liable under a secondary theory of liability, aiding and abetting. The Ninth Circuit has concluded:

> Generally, where there is an error of law in submitting one of a number of theories to the jury, the general jury verdict is tainted because it is impossible for the reviewing court to determine with certainty whether the theory upon which the jury based its verdict is a proper theory.

Counts v. Burlington, 952 F.2d 1136, 1140 (9th Cir. 1991). The court, however, will not disturb a verdict if the correct theory of liability is supported by "substantial evidence" and free from error. *Kern v. Levolor*, 899 F.2d 772, 777 (9th Cir. 1990). To determine whether the court should grant a new trial, the court must analyze the following factors:

> (1) the potential for confusion of the jury, (2) whether the losing party's defenses apply to the count upon which the verdict is being sustained, (3) the strength of the evidence supporting the count relied upon to sustain the verdict, and (4) the extent to which the same disputed issues of fact apply to the various legal theories.

Counts, 952 F.2d at 1140.

The court finds the potential for juror confusion to be low. The plaintiffs did not emphasize a theory of secondary liability to the jury or urge the jury to return a verdict in their favor on the basis of secondary liability. Instead, the evidence relating to the defendant focused upon the alleged deceptive financial statements. The primary evidence presented against the defendant related to the defendant's failure to include a "going concern" qualification.

The dispute over the defendant's liability consisted primarily of a battle of the experts. The plaintiff's expert, Patricia Glietsmann, testified an auditor acting consistently with industry standards would have included a going concern qualification. She testified the failure to include such a qualification constituted such an extreme deviation from settled practice so as to suggest willful blindness. The plaintiff introduced numerous documents and testimony

showing the defendant was aware of the risk but nevertheless failed to include a going concern qualification.

For example, ATV was delinquent in its tax obligations because ATV did not have sufficient cash to pay the taxes. The company was delinquent on various taxes, including sales and payroll taxes. The company also was unable to pay numerous vendors. Finally, the defendant was aware of substantial litigation against ATV.

The parties concede that if the defendant would have included a qualification, the initial public offering would not have gone forward. The court also has found in its prior Memorandum Decision and Order Denying Motions for Judgment Notwithstanding the Verdict and for a New Trial, that substantial evidence supports the plaintiff's theory that the defendant failed to include a qualification because the defendant was motivated by the desire to garner substantial fees. Thus, the focus of the evidence presented against the defendant was evidence relating to the plaintiff's theory that ATV's financials materially misstated the company's current economic posture and known future prospects. This evidence against the defendant establishes primary rather than secondary liability. Further, in his closing argument, counsel for the plaintiff emphasized this evidence regarding the financials and did not focus on a secondary theory of liability. Accordingly, the court finds it unlikely that the jury found the defendant liable on a secondary theory of liability or that the jury was otherwise confused.

Second, the defendant's defenses relating to both theories are essentially the same. The defendant asserted the statements within the financials were not deceptive. The jury necessarily rejected this defense in returning a verdict for the plaintiffs. Thus, the same issues of fact also related to both theories. The primary dispute was over whether the financials were in fact deceptive. A jury's finding in favor of the plaintiffs was sufficient to subject the defendant to primary liability.

Finally, the court has already found the evidence to be substantial against the defendant in the Memorandum Decision of May 6, 1993. Specifically, the court found the plaintiffs presented sufficient evidence to allow the jury to find, (1) the mix of information contained in the prospectus and its included financials materially misstated the company's current economic posture and known future prospects, (2) the defendant either subjectively knew of the misstatements or was willfully blind to them, and (3) the defendant was motivated by the desire to garner substantial fees. The court also found the evidence was sufficient to convince a reasonable jury that the defendant was aware the scaled back offering would dramatically impact ATV's liquidity. Nevertheless, the defendant failed to include a going concern qualification. The court, therefore, finds the evidence sufficient to support liability under a primary theory of liability. Accordingly, viewing the record as a whole, the court finds the defendant is not entitled to a new trial.

E. SUPPLEMENTAL BRIEFING

In their supplemental briefing, the plaintiffs also shall provide the court with the total amount of judgment to be entered in this action without aggregate damages. The plaintiffs shall specify the amounts which constitute the judgment. The plaintiffs also shall provide the court with the sum total of the previously awarded attorney's fees and expenses. The plaintiffs shall submit this briefing by July 20, 1994, and the defendants may respond by July 27, 1994. The court will then issue a final judgment terminating the action at this level.

IT IS SO ORDERED.

Dated: 7/14/94

Marilyn L. Huff, Judge
United States District Court

APPENDIX D

UNITED STATES DISTRICT COURT
S.D. CALIFORNIA

No. CV 87-0067 H(M)

KNAPP

v.

GOMEZ, et al.

May 5, 1993

HUFF, District Judge.

Defendants moved for judgment as a matter of law under Federal Rules of Civil Procedure 50(b) or in the alternative for a new trial under Rule 59. The court heard argument on these motions on January 15, 1993. The motions primarily challenge the sufficiency of the evidence to sustain the verdict, although there is a threshold issue, the constitutionality of section 27A of the 1934 Securities and Exchange Act, which presents a pure question of law.

As a preliminary matter, because the judge who tried the action is now deceased, the rules require the judge to certify familiarity with the record. FRCP 63. This court presided over the action until the eve of trial and thus was already familiar with the procedural and factual history of the case. This court reviewed the entire transcript of the trial proceedings, the exhibits relevant to the motions, and the post trial motions. This court certifies that it is familiar with the case as required by Rule 63.

I. Transactional Events

ATV was founded by Philip Gomez, Douglas O'Connor and Frank Gleason in 1981. The company specialized in point-of-sale microprocessing systems designed for retail

applications and also dealt in more generalized data processing and communications equipment for office use. ATV covered the gamut of operations from development to manufacturing to marketing and service. The principals had experience in the high-tech field and considered themselves well-versed in "turn-around" techniques. They were experienced in taking troubled companies, slashing waste, increasing productivity, improving the bottom line, and turning the companies around to profitability. There were many businesses in need of such redirection in the early 1980s because interest rates were high and credit was tight. ATV's modus operandi was to acquire these bankrupt companies at bargain prices, liquidate unprofitable product lines and merge profitable lines into its own operations.

Although ATV acquired research at wholesale prices which would have required years to develop independently, ATV also acquired the management, marketing, production and service woes which brought the companies down in the first place. In other words, ATV acquired assets which might become valuable in the future as R & D ripened into product lines, but at the same time acquired significant current liabilities and start-up costs as operations were restructured and redirected.

Because of these features, ATV was a cash-hungry venture and the founders' personal resources were fast becoming inadequate to meet the challenge. The founders first considered taking the company public in late 1982, but the company needed financial assistance immediately. Help arrived in the form of a $10 million injection of funding in early 1983 from various venture capital investment groups. ATV in return issued convertible debentures.

The debenture holders were not interested in the long haul. The game plan was to boost ATV's respectability in the industry to the point where it could be taken public. The debenture holders would then exercise their conversion rights and sell their shares on the open market. If all went well, the

venture capitalists would recoup their $10 million plus a tidy profit, ATV would be out from under the burden of the debt and positioned to pursue its aims even more aggressively, and the founders, through their stock holdings, would be wealthy individuals.

All did not go well. As a practical matter, taking the company public was now no longer an option but a necessity. A failure to go public would not only trigger an obligation to retire most of the debenture debt but also would increase that debt by $2 million. In retrospect, ATV was not well-positioned to make a public offering. ATV, however, did proceed with the public offering. The founders retained a prestigious securities law firm, a "Big 8" accounting firm, and E.F. Hutton as lead underwriter during the spring and summer of 1983.

As originally planned, the initial public offering ("IPO") was to be 2.2 million shares with a price range of $15-18 per share. As time passed, the number of shares and the price per share declined. When the company filed the preliminary prospectus with the SEC in August of 1983, it still proposed to issue 2.2 million shares, but the price had dropped to $13-15. In the end, E.F. Hutton further reduced the price to $10 and the number of shares to only 600,000. By that time, high-tech IPO's had fallen out of favor with the market and ATV's "road shows" had not generated the interest expected. Thus, instead of the $30 million ATV hoped to generate, the gross would be only $6 million. Most of the 600,000 shares would be sold by the debenture holders and after deducting substantial legal and accounting fees and other costs incurred in putting the IPO together, ATV realized virtually no net cash. In fact, Gomez would draft an internal memorandum indicating the IPO cost ATV money. Taking the company public accomplished two things. ATV was relieved of some debenture debt, and the stage was set for this lawsuit.

The IPO was effective on October 18, 1983. Beginning in January of 1984, ATV released a series of negative

earnings reports and the stock reacted sharply. Far from being a growth company poised for continued expansion, as suggested by the prospectus, it became clear to the market that ATV was not doing well. In the same quarter the IPO occurred, ATV recorded a net loss of almost $2 million thereby giving back virtually all of the profits reported for fiscal year 1983. ATV would ultimately post a loss of more than $31 million for the fiscal year ending March 31, 1984. The stock was delisted by NASDAQ. ATV returned to a position of modest profitability, but finally closed its doors in 1988.

Investors who had purchased at $10 per share and sold for a quarter of that amount scant months later wondered if there was more to the story than unexpected business reversals. This action followed against defendants Gomez, O'Connor and Gleason, E.F. Hutton, Ernst & Whinney (now Ernst & Young), the debenture holders who exercised their conversion rights, two ATV board members, John Flood and Paul Sullivan, Peter Young, the company's controller, Michael Conners, the chief financial officer, John Nicholas, the in-house counsel, and ATV's outside counsel, Michael Connell. The plaintiff asserted liability on a variety of theories including RICO, Rule 10b-5 and a panoply of state law claims.

All defendants settled pretrial, or were otherwise out of the case, except for Gomez, O'Connor and Ernst & Whinney ("E & W"). At the conclusion of the evidence, the Court dismissed the RICO count and the pendent claims. Memorandum entered April 22, 1992. The court submitted only the 10b-5 claim to the jury. The jury found all three defendants liable, they accepted plaintiff's entire damage theory and they did not hold any settling defendant responsible.

II. Analysis

A. Constitutionality of Section 27A

By Order dated August 23, 1991, plaintiff's 10b-5 claim was dismissed as time-barred pursuant to *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, — U.S. —, 111 S.Ct. 2773 (1991) (imposing uniform federal three-year period of repose and one-year discovery rule on 10b-5 claims). The *Lampf* Court applied the newly announced rule to the case before it. *Lampf* did not address whether the decision was retroactive as to all pending actions. On the same day as the *Lampf* decision, the Supreme Court issued an opinion holding that if a new rule is retroactive at all, it is retroactive as to all pending actions. *James B. Beam Distilling Co. v. Georgia*, — U.S. —, 111 S.Ct. 2439, 2447-48 (1991).

Lampf provoked a prompt congressional response and on December 19, 1991, the President signed into law the Federal Deposit Insurance Corporation Improvement Act of 1991 which provides, *inter alia*:

> (a) EFFECT ON PENDING CAUSES OF ACTION. — The limitation period for any private civil action implied under section 10(b) of this Act that was commenced on or before June 19, 1991, shall be the limitation period provided by the laws applicable in the jurisdiction, including principles of retroactivity, as such laws existed on June 19, 1991.
>
> (b) EFFECT ON DISMISSED CAUSES OF ACTION. —Any private civil action implied under section 10(b) of this Act that was commenced on or before June 19, 1991—
>
> (1) which was dismissed as time barred subsequent to June 19, 1991, and
>
> (2) which would have been timely filed under the limitation period provided by the laws applicable in the

> jurisdiction, including principles of retroactivity, as such laws existed on June 19, 1991, shall be reinstated on motion by the plaintiff not later than 60 days after the date of enactment of this section.

P.L. No. 102-242, § 476, 105 Stat. 2236 (codified at Securities Exchange Act of 1934, § 27A, 15 U.S.C. § 78aa-1).

Pursuant to section 27A, plaintiff moved for reinstatement of the 10b-5 claim on the eve of trial. Defendants did not object. Courts applying *Lampf* shortly after enactment of the 1991 amendments merely noted in passing that section 27A overruled the decision insofar as retroactive application is concerned.[1] *See, e.g., Ockerman v. May Zima & Co.*, 785 F. Supp. 695, 705 n.10 (M.D. Tenn. 1992); *Mekhjian v. Wollin*, 782 F. Supp. 881, 885 (S.D. N.Y. 1992); *Ahmed v. Trupin*, 781 F. Supp. 1017, 1021-22 (S.D. N.Y. 1992). After the trial in the instant case concluded, the district courts scrutinized more closely the Congressional action.[2]

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[1] The court is addressing the merits notwithstanding defendants' failure to raise the issue either in the pretrial order or in their FRCP 50(a) motion because only eighteen days elapsed between enactment of section 27A and commencement of trial.

[2] Among those published decisions declaring section 27A unconstitutional in whole or in part are *Johnston v. Cigna Corp.*, 789 F. Supp. 1098, 1099 *et seq.* (D. Colo. 1992); *Bank of Denver v. Southeastern Capital Group, Inc.*, 789 F. Supp. 1092, 1094 *et seq.* (D. Colo. 1992); *In re Brichard Sec. Lit.*, 788 F. Supp. 1098, 1104 *et seq.* (N.D. Cal. 1992); *TGX Corp. v. Simmons*, 786 F. Supp. 587, 591-94 (E.D. La. 1992); *see also, Treiber v. Katz*, 796 F. Supp. 1054, 1059-62 (E.D. Mich. 1992) (confined to holding section 27A(b) invalid as applied to final unappealed judgments); *Plaut v. Spendthrift Farm, Inc.*, 789 F. Supp. 231, 234-35 (D. Ky. 1992) (same). The statute has passed muster in *Maio v. Advanced Filtration Systems, Ltd.*, 795 F. Supp. 1364, 1371-76 (E.D. Pa. 1992); *Brown v. Hutton Group*, 795 F. Supp. 1307, 1313-16 (S.D.

Significantly, the Courts of Appeal, including the Ninth Circuit, have uniformly upheld the constitutionality of Section 27A.[3] *Gray v. First Winthrop Corporation*, 93 Daily Journal D.A.R. 4406 (9th Cir. April 8, 1993); *Anixter v. Home-Stake Production Co.*, 977 F.2d 1533, *on rehr'g*, 977 F.2d 1549 (10th Cir. 1992), *pet. for cert. filed*, 61 U.S.L.W. 3455 (Dec. 11, 1992); *Henderson v. Scientific-Atlanta, Inc.*, 971 F.2d 1567, 1571 *et seq.* (11th Cir. 1992); *McCool v. Strata Oil Company*, 972 F.2d 1452, 1457-58 (7th Cir. 1992); *Berning v. A.G. Edwards & Sons, Inc.*, 990 F.2d 272 (7th Cir. Mar. 25, 1993); *Hirschler v. GMD Investments Ltd.*, 972 F.2d 340 (4th Cir. 1992).

Congress enacted new law with section 27A. *Gray*, 93 D.A.R. at 4408. *TGX*, *supra*, 786 F. Supp. at 592. There was no effort to declare what the law means; only to change what it is. *See generally*, *Robertson v. Seattle Audubon Soc.*, — U.S. —, 112 S.Ct. 1407, 1412-14 (1992). Congress did not direct any particular result. *Id.* Instead, Congress directed courts to render a decision on such facts as might be found based on the law as it existed prior to June 20, 1991. *Treiber*, *supra*, 796 F. Supp. at 1058-59. Thus, there is no

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N.Y. 1992); *Cortes v. Gratkowski*, 795 F. Supp. 248, 250-51 (N.D. Ill. 1992); *In re American Continental Corporation/Lincoln S & L Sec. Lit.*, 794 F. Supp. 1424, 1439-40 (D. Ariz. 1992); *Lundy v. Morgan Stanley & Co.*, 794 F. Supp. 346, 348 *et seq.* (N.D. Cal. 1992); *Wegbreit v. Marley Orchards Corp.*, 793 F. Supp. 965, 969-70 (E.D. Wn. 1992); *Adler v. Berg Harmon Assocs.*, 790 F. Supp. 1235, 1242-45 (S.D. N.Y. 1992) (collecting unpublished decisions); *Venturtech II Ltd. Partnership v. Deloitte Haskins & Sells*, 790 F. Supp. 574, 576 (E.D. N.C. 1992); *Axel Johnson, Inc. v. Arthur Andersen & Co.*, 790 F. Supp. 476, 478 *et seq.* (S.D. N.Y. 1992).

[3] Although, the opinions are unanimous in their outcome, *Henderson* drew a dissent. 971 F.2d at 1575 (Wellford, J., dissenting).

violation of the separation of powers doctrine. *Gray*, *supra*, 93 D.A.R. at 4409; *Henderson*, *supra*, 971 F.2d at 1571-73. Furthermore, there is no violation of due process or equal protection as the statute is rationally related to a legitimate purpose.

B. JNOV/New Trial

1. Applicable Standards

In the absence of a clear failure of proof, courts are reluctant to displace the jury's role as the finder-of-fact. *See Ortiz v. Bank of America Nat. Trust and Sav. Ass'n*, 852 F.2d 383, 388 (9th Cir. 1988). The mere fact that the trial judge might have found differently does not allow for a substitution of judgment. *Tennant v. Peoria & P.U. Ry. Co.*, 321 U.S. 29, 35 (1944). A judgment notwithstanding the verdict under FRCP 50(b) is appropriate only when, casting aside questions of weight and credibility, the evidence could yield only one rational result. *Yeaman v. United States*, 584 F.2d 322, 326 (9th Cir. 1978); *Cockrum v. Whitney*, 479 F.2d 84, 85-86 (9th Cir. 1973). That is not the case here.

The defendants have also moved for a new trial. While a lesser showing is required to warrant retrial, and although a court is free to weigh the facts and to exercise a measure of discretion, there must be reason to believe the verdict results in a miscarriage of justice or is at odds with the great weight of the evidence. *Venegas v. Wagner*, 831 F.2d 1514, 1519 (9th Cir. 1987); *Digidyne Corp. v. Data General Corp.*, 734 F.2d 1336, 1347 (9th Cir. 1984), *cert. denied*, 473 U.S. 908 (1985).

Applying the standards to the evidence in the case, the court denies the motions for judgment notwithstanding the verdict and for new trial. There was substantial evidence to support the jury's verdict. Nevertheless, the court will examine the defenses' challenges to the evidence of scienter, expert testimony, reliance and damages.

2. Scienter

The court rejects the argument that there was insufficient evidence of scienter. There was substantial evidence establishing that ATV was not positioned to continue to expand if the initially planned IPO were unsuccessful. ATV required a massive infusion of capital. *See Huddleston v. Herman & McClean*, 640 F.2d 534, 544 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). The cash crunch which precipitated the nonpayment of taxes and vendors was already built into the system. ATV needed the higher proceeds from the IPO as initially planned plus additional financing to meet its objectives. *Exhibit 253* at p. 12. Despite the reduction in the anticipated proceeds from the revised offering, the discussion of liquidity and capital resources in the preliminary and final drafts of the prospectus are virtually identical. *Compare Exhibit 4a* at p. 12-13 with *Exhibit 253* at p. 12. The only modifications are that the final draft disclosed that future equity offerings were anticipated and the fact that certain acquisitions were plagued with weak internal controls. The jury could have found that the defendants were reckless in using same language to describe the liquidity of a company which intended to realize over $20 million of new capital and a company which would gain almost no net infusion.

There was sufficient evidence developed through three of E & W's auditors, Sabin, Martindale and Gulko, to convince a reasonable jury that E & W was aware that the scaled back offering would dramatically impact ATV's liquidity. *Exhibit 169*, p. 34 ("the pending public stock offering is critical to the Company's continued long-range existence"). Mr. Sullivan, a settling ATV outside director, had testified before the SEC:

[The two million dollars] was far from the target and not adequate at all to carry on the business.

TR: 3108.

E & W urges that the Dow Jones News Wire service story that the IPO had been drastically reduced (*Exhibit LG*), cures all which went before. The jury could take this disclosure into account, but it could also conclude that the only effective cure from ATV's perspective to protect the investors would be to either fully disclose the impact of the reduced IPO in the prospectus or abandon the effort. The jury could also conclude that the only effective cure from E & W's perspective would be to either assure that the prospectus made fair disclosure or withdraw from the IPO.

There was substantial evidence of a mischaracterization of certain leasing transactions as income rather than as a liability. ATV mischaracterized the leasing transactions as sales in the sum of $1,342,142 and hence as income. However, the recourse feature of the sales rendered them liabilities for accounting purposes. All concerned agree that in retrospect, proper GAAP reporting would have resulted in a far less impressive earnings statement. Sabin, the auditor, relied solely on O'Connor, a non-accountant and non-lawyer, for his characterization of the transactions as sales resulting in income. The auditor did not read the underlying contracts which would have demonstrated O'Connor to be wrong. Gulko conceded that an auditor would be justified in relying on management characterization in conducting a review only if "the person was a competent person and understood the accounting ramification." The jury could have concluded that the defendants were reckless under these circumstances by mischaracterizing over one million dollars of "income."

There was also substantial evidence of ATV's weak internal controls which, the jury could have found, all but guaranteed that statements prepared by the company in 1983 would be materially inaccurate. The inventory controls were particularly weak. Having acquired a variety of product lines subject to different inventory systems, ATV could overlook 100 widgets in stock because the widgets were in different locations and listed under different part numbers. This led to

understated writedowns for excess or obsolete inventory. Moreover, E & W was aware of this serious flaw and nonetheless associated on the unaudited financials which E & W suspected to be inaccurate.

There was also evidence relating to the "due from partnership" issue. Plaintiff contended that the prospectus did not adequately disclose that ATV had a problem on its balance sheet concerning a "due from partnership" receivable owed to it. The receivable was a debt owed to it by companies in bankruptcy, and therefore, was probably uncollectible. E & W failed to reserve, write off or qualify the debt on the auditor's opinion, allowing the IPO to go forward.

Additionally, the due-from-partnership account was misrepresented as a collectible receivable in the prospectus since it was collateralized by future shares of stock in ATV Systems. If the IPO went forward, the debt could not be shifted to the debenture holders. The right of offset would not accrue until after it was extinguished. However, the value of the collateral would be dependent upon the market value of the stock subject to periodic revisions designed to maintain a 4/1 ratio between current share value and current "due-from-partnership" debt.

The greater the amount of stock pledged in the future, the greater the impact of releasing new shares into the market. Although the prospectus disclosed that the number of collateralized shares exceeded the number of shares sold in the IPO, the drafters could have explained more fully the impact of the due from partnership account on the market value of the stock. The jury could have concluded that ATV and E & W were reckless in failing to accurately and completely disclose this information.

Therefore, the plaintiffs established scienter from material misrepresentations and omissions in the prospectus concerning ATV's ability to remain in existence, an admitted overstatement of income from the leasing transactions, the

weak internal controls which raised substantial questions about the validity of the unaudited financials, and the lack of complete candor about the collectibility of the due from partnership account.

The jury could conclude from the evidence that E & W either subjectively knew of the misstatements or was willfully blind to them. Additionally, the jury could make a reasonable inference from the evidence that E & W was motivated by the substantial fees which came from its association on the IPO. Indeed, the evidence showed that an E & W associate (Ralph Sabin) was trying to "position" E & W to bring in $500,000.00 in consulting fees from ATV, in addition to the $500,000.00 in audit fees which E & W was paid after the IPO went forward. (*See* Ex. 162).

The court properly instructed the jury on the burden plaintiff faced in establishing scienter by defendants. Additionally, the court gave a separate instruction reiterating the standard in order to cure a misstatement made by O'Connor in his closing argument.[4] The jury was well aware that mere carelessness or oversight was insufficient. The jury was further instructed that before liability could be imposed, the defendants must have acted with intent or recklessness. Based on the instructions and the evidence, there was ample evidence of defendants' recklessness to support the verdict.

3. Expert Testimony

Even without the expert testimony of Patricia Glietsmann, there is substantial evidence of scienter to support the verdict. Gleitsmann testified that an auditor acting consistently with industry standards would have included a "going concern" qualification. She further testified that the failure to do so constituted a deviation from settled practice so striking as to suggest willful blindness. *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc)

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[4] O'Connor argued he had not been negligent.

(defining recklessness in context of 10b-5), *cert. denied*, — U.S. —, 111 S.Ct. 1621 (1991); *see also Levine v. Diamthuset, Inc.*, 950 F.2d 1478, 1484 (9th Cir. 1991). Although counsel have radically different views on the value of Gleitsmann's testimony, there was a proper foundation for her status as an expert,[5] and she was cross-examined at length about the potential holes in her theory, particularly her contested reading of AU 340. It was within the province of the jury to believe her testimony and reject contrary expert testimony in light of all the evidence in the case.[6]

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[5] Ms. Gleitsmann received her masters in accounting in 1974 and has been a certified public accountant since 1975. She was with the big eight accounting firm of Price Waterhouse for 16 years, rising to the position of partner. She was in Price Waterhouse's audit division for eight years and then in the newly formed entrepreneurial services division. She was in charge of the entrepreneurial services department in Oakland. She was a designated high technology partner within the Price Waterhouse firm. She worked on at least twenty initial public offerings while at Price Waterhouse. She taught accounting courses at the university level and within Price Waterhouse. She is a member of the American Institute of Certified Public Accountants, the California Society of CPA's and the Institute of Business Appraisers. Furthermore, the defendants never moved to strike her testimony as to any of her opinions.

[6] There were numerous red flags in E & W's workpapers and Summary Review in evidence which supported a more thorough going concern analysis by E & W. Some examples of this evidence include:

Ex. 39, p. 12 (management Letter from E & W to ATV Board delivered about September 18, 1983) (sales taxes of almost $1 million unpaid because of cash flow considerations)

Ex. 67, p. 11-3-6, June 22, 1983 ("Mgmt. made the decision not to pay these sales taxes until the company is caught. E & W feels this is improper business practice and prompt pymt. of all

sales taxes should be made. As this is an early sign of financial problems and a red flag for all controlling authorities (SEC, IRS, etc.)."

Sam Gulko was aware prior to the IPO that the Company was not paying sales taxes:

> A. It was not paying its taxes because it didn't have the cash at the time to pay its taxes, and taxes, were, um, lumped in with the other vendors that the company was not paying at that time. (RT 7:1544).

He described the Company during fiscal 1983: "They were tight on cash. They didn't have any money. They were ... operating on a day-by-day basis. It was a struggling company." RT 7:1550.

E & W knew that the Company was late paying on various taxes and payables, *see* RT 10:2056, such as payroll taxes, *see* RT 7:1546, which Gulko conceded was relevant to going concern. In fact, testimony suggested that ATV had (contrary to the prospectus, (Ex. 4a, p. 6)), used the proceeds of the IPO to pay delinquent payroll taxes (Ex. 193) or had to pay off arrearages to get the IPO out the door (as O'Connor testified RT 6:1364). *See also* Ex. 37, p. 37. The Company also took "aggressive" positions in not paying its federal income taxes (*see* Ex. 169 p. 28; RT 15:3425). Shortly after the IPO, the Company essentially stopped paying payroll taxes, amassing an almost $1.9 million in arrearages by December 31 (Ex. 21 p. 13), which arrearages the Company blamed on the shortfall in the IPO (Ex. 275).

The plaintiff introduced substantial evidence of the Company's negative aging trade payables, (75% over 90 days by 9/30/89) (RT 9:1885) extending vendors, and having to pay a large percentage of vendors on a C.O.D. basis. *See* Ex. H-G, 133, JR, 111 and RT 3:602; 4:633, 655; 6:1205; 7:1606 and 10:2043. ATV was out of compliance with at least two loan covenants with its major lender, giving CalFed the right to declare a default and accelerate the note. *See* Ex. 235. Both Sabin and Gulko were aware of the loan and its major provisions. RT 7:1558 (Gulko); RT 16:3524 (Sabin); Ex. 235, p. 18-19; Ex. 137. With acknowledged delinquencies in sales

In relying on AU 326, E & W reads too much into the utility of the standard in this proceeding. While auditing is an inexact science, there are parameters within which reasonable minds might honestly arrive at differing conclusions. *SEC v. Keller Indus., Inc.*, 342 F. Supp. 654, 658 n.7 (S.D. N.Y. 1972). There are also external considerations

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taxes and chronic late payment of payroll taxes, (Exs. 39, 67) ATV was in violation of the loan covenant requiring it to promptly pay its taxes.

The Company had substantial litigation against it (RT 10:2028-29 (Gleitsmann); RT 12:2709 (Connell)). ATV's ability to meet its internal sales forecasting as a way to generate revenue was known to E & W to have been highly questionable. *See* Ex. 4a p. 47 and Ex. JR p. 9. (In fiscal 1983, the Company forecast $78 million in revenue and made only $44 million, missing the forecast by 43%). E & W noted that their forecasting was "overly optimistic"; a conclusion they reached again in August, 1983. E & W was also aware in August, 1983 that "CRS sales have been on a downward trend since the end of May, July sales were poor also" and that "sales to Foodmaker—aka Jack-in-the-Box ended in May, as the 1 year contract came to an end") (Ex. 83, p. 2-1-9; *see also* Ex. 285 re: sharp drop-off in Medallion sales) and of the large operating loss which the Company had in July and August (Ex. 75 p. EW 318676). E & W was also aware that ATV had used its bank borrowings to purchase Docutel-Olivetti and for working capital and in the words of Ralph Sabin was, at the time of the offering "maxed-out leverage wise." (Ex. 85, p. 2) RT 5:1051-52. E & W had also been aware that the Docutel-Olivetti service organization was causing drops in ATV sales and negative aging in payables (Ex. JR at 6). The fact that the Docutel-Olivetti acquisition was going to be a problem for the Company was, according to Mr. Gomez, discussed at all-hands meetings. RT 2:372-73, 378-79.

such as cost and time constraints which affect the decision of how much effort is too much effort.[7]

The problem with E & W's reliance on the standard in this proceeding is two-fold. First, an auditor cannot insulate himself or herself from liability by making a self-serving determination that he or she has used sound judgment. Whether that judgment was reckless must still be scrutinized under the industry criteria employed in applying the standard.[8] Second, the place to argue AU 326 was before the jury. The standard is not so inflexible and self-defining as to be interpreted and applied as a matter of law.

In sum, plaintiff presented evidence from which the trier of fact could reasonably have found: (1) the mix of information contained in the prospectus and its included financials materially misstated the company's current economic posture and known future prospects; (2) E & W either subjectively knew of the misstatements or was willfully blind to them; and (3) E & W was motivated by the desire to garner substantial fees.[9]

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[7] When the effort required cannot be economically justified, the answer is to decline the project rather than to perform substandard work. *Cf.*, AU 722.

[8] This was not a malpractice case and the jury was so instructed. Compliance with industry standards was relevant only insofar as the jury could consider whether a deviation from normal practice was so aberrant as to suggest deliberate or reckless conduct.

[9] One appellate panel has held, apparently as a matter of law, that an accounting firm (which happened to be E & W) would not engage in fraud merely to build fees. *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, — U.S. —, 111 S.Ct. 347 (1990). Motivation in this case is better cast as a question of fact. At an institutional level, it would indeed be remarkable for a professional accounting organization to jeopardize its standing in the community to build fees. However, the jury could have

4. Reliance

Neither plaintiff Knapp nor any other class member testified. For purposes of trial, plaintiff relied entirely on the various doctrines of presumed reliance in federal securities law. A "presumption" is just that. Once in place, the jury may find the presumption to be a fact unless rebutted. *Basic v. Levinson*, 485 U.S. 224, 248-49 (1988). It is difficult to put on rebuttal evidence in the abstract. *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975). This is particularly so when the inaccuracy is cast as an omission rather than an affirmative misrepresentation. In that case, the jury must find that the investment would have been made even with knowledge of the falsity, and that the investor was either aware of the omission or would have acted even with such awareness. Not surprisingly, defendants failed to rebut the presumption.

The trial judge explained the legal underpinnings of the various doctrines on which the jury was instructed in the Memorandum entered April 22, 1992. This court incorporates by reference that decision into this opinion. Summarizing the evidence adduced at trial as it relates to those doctrines, the jury was entitled to find both affirmative misstatements and omissions. While the experts disagreed on whether ATV stock traded in an efficient market, the jury could have found from the evidence presented that the market did react to adverse earnings reports. Finally, there was credible testimony supporting the premise that the stock would not have issued at all but for the misstated and omitted information.

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concluded from the evidence that the individuals from E & W involved in these transactions were prompted by personal career motives which may not have meshed with E & W's best interests. *See* Ex. 162 in which Ralph Sabin was trying to "position" E & W to bring in $500,000.00 of fees for the IPO.

5. Damages

The jury assessed the stock value based on the expert testimony of John Torkelson. If one accepts Torkelsen's theory, his figures logically flow. E & W relies on the fact that the various omissions and misrepresentations had not been cured by the date Torkelsen selected for determining "true value." This has little impact for two reasons. First, the negative earnings reports served as the functional equivalent of disclosing the underlying causes. Second, the jury was entitled to accept or reject Mr. Torkelsen's opinion of the stock value.

The defense expert, M. Chapman Findlay hypothesized that if a corporate officer commits fraud and the plant then burns down before the fraud is discovered, any reduction in market value of the stock cannot be a function of the fraud but rather is due to the unrelated fire. The jury rejected Mr. Findlay's analogy.

The system credits jurors with common sense. In fact, the jury was expressly directed to use its collective common sense. Illiquidity, overstated earnings and inflated balance sheets bear a closer relationship to a precipitous drop in earnings than fraud does to fire. E & W's argument that the precise misrepresentation made must be precisely corrected would yield the anomalous result that ATV investors could never establish damages. However, the record reveals that none of the misstatements and omissions complained of were expressly corrected prior to the company closing its doors.

Nor does Torkelsen's assumption that all omissions and misstatements alleged were well founded undercut the damage award. Loss causation must be proven. *Blackie*, *supra*, 524 F.2d at 909 n. 25. Under defendants' view, each discrete wrong must be shown to have caused discrete damage. Taken to its logical end, the jury would be required to find, for example, that the failure to writedown for excess inventory accounted for 12.23% of the loss, or that misreporting the

lease transactions as sales resulted in 29.77% of the loss. That task disregards the cumulative impact of the omissions and misstatements. The wrong is increased by the inadequacy of the total mix of information. Torkelsen's theory accounts for that injury and does so consistently with the value actually assigned by the market.

In the final analysis, the market sets value. There were no cataclysmic events impacting the market during the relevant time frame. Torkelsen's theory takes into consideration general market trends which might have affected value independently of the misinformation factor.

The Torkelsen/Findlay credibility battle has already been waged in front of the jury. Both were qualified as experts. The court instructed the jury that if the experts' assumptions were not satisfactory, the conclusions of either or both could be disregarded in their entirety. Consistent with that instruction, the jury accepted Mr. Torkelsen's opinion of stock value. Accordingly, this court declines to set aside the jury's determination of value which was supported by substantial evidence.

6. Allocation of Fault

E & W urges that the verdict is necessarily inconsistent because the jury could not have held the auditors responsible for statements in the prospectus without also finding Connell and E.F. Hutton liable. However, there was no evidence in the case from which the jury could have quantified third-party fault. Rather than try the empty chair, defendants made a strategic decision to urge that nothing was wrong with the offering. That may be tactically wise in some cases, but the jury disagreed. The failure of evidence falls on the party with the burden, the defense in this case. Even if the jury could have found malpractice on the part of the settling defendants, there was no evidence from which the jury could infer scienter.

The jury was instructed to make plaintiff whole. Since the jury awarded every nickel requested, presumably it did so. In addition to recovering for the whole injury, plaintiff also collected $1,953,000 in pretrial settlements. In other words, plaintiff achieved a 145% satisfaction.[10] Nevertheless, the Ninth Circuit in *Franklin v. Kaypro Corp.*, 884 F.2d at 1230-32 (1989), *cert. denied sub nom., Franklin v. Peat Marwick Main & Co.*, — U.S. —, 111 S.Ct. 232 (1990) foresaw that possibility.

The end result of the verdict is not fair, but is compelled by *Kaypro*. *Kaypro* has been criticized as violative of the "one satisfaction" rule. *See Dalton v. Alston & Bird*, 741 F. Supp. 157, 160 (S.D.Ill. 1990); *see also*, *MFS Mun. Income Trust v. American Medical Intern., Inc.*, 751 F. Supp. 279, 282 *et seq.* (D. Mass. 1990). The facts illustrate why *Kaypro* has the potential for creating inequity.

However, there is another feature not explored by *Kaypro*. The opinion characterized all defendants in securities cases as "wrongdoers." *Id.* at 1230-31. Not all defendants concur. The nonsettling defendants in this case did not. That is why they went to trial. Their defense was premised in part on the theory that these particular defendants had done nothing wrong, and more broadly, that nothing was wrong with the IPO. Rather, plaintiff's losses were caused by an unexpected reduction in revenues and other business reversals.[11]

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[10] Albeit, the settlements compromised RICO and pendent claims as well. As the facts demonstrated at trial, this was not a RICO case. The pendent claims, however, were not dismissed on the merits but out of concern over comity and confusion. Memorandum entered April 22, 1992.

[11] The pro se defendants came the closest to trying the empty chair. Still urging that no one had done wrong, they argued that if someone had acted wrongly, it must have been one of the profes-

That is a reasonable tactical call, albeit an unavailing one in hindsight. By taking that approach, however, defendants effectively foreclosed any reduction of their liability through pretrial settlement activity. The practical effect of *Kaypro*, then, is that a defendant must either concede that someone might have engaged in fraud and try the empty chair, or run a win-all/lose-all gamble by failing to put on evidence of another's wrongdoing. In effect, the burden under *Kaypro* shifts to a nonsettling defendant to prove an element of plaintiff's case. This Hobson's Choice is an unattractive one, foreclosing a valuable defensive maneuver which would remain available without *Kaypro*.

Nonetheless, this is not a case where the Court sees the verdict as a perversion of justice warranting another lengthy jury trial. Unlike the scenario in *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990), where unpredictable and uncontrollable external forces threw an entire market into shambles, this was not a case of "unanticipated change in market conditions" or at least, if the "change" was unanticipated, it should not have been. On the basis of all the evidence, the jury was justified in its verdict. Therefore, the Court denies E & W's motions for judgment notwithstanding the verdict and for a new trial.

While the court's ruling has focused on E & W, the pro se defendants' motions suffer the same fundamental flaws. Issues of credibility are for the jury. The Court cannot reweigh the facts, redetermine believability or resolve disputed inferences. To be sure, there were many triable issues on all three fronts. That is why the court denied the motion for summary judgment and empaneled a jury. Additionally, the disputed evidentiary rulings are not cause to set aside the verdict. The trial judge was convinced at the

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sionals to whom they had entrusted their fate and to whom they had paid large sums of money for advice.

time of rendering those rulings of their correctness and this Court remains so today.[12]

For reasons stated in the Memorandum entered April 22, 1992, the Court does not see what Gomez and O'Connor did as fraud in the classic sense. On the contrary, it is clear they believed in ATV and were prepared to put their best efforts into taking the venture to a successful conclusion. That is why they would continue to pour their own resources into the company even when things looked ominous. That is also why they would take salary reductions and even waive salary in some instances. Moreover, they did not profit personally from the IPO.[13] Finally, although control persons could certainly be charged with knowledge that the prospectus was less than candid, they relied on attorneys, accountants and the underwriter for the proposition that such lack of candor constituted an acceptable practice.

Be that as it may, the jury could reasonably conclude from the evidence that the investing public was entitled to a more complete and accurate mix of information than it received, and that the failure of information was either

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[12] Defendants' most vigorous protest goes to the Court's refusal to allow evidence that the SEC had undertaken an in-depth investigation into the very events which were the subject of trial and took no adverse action. The Court ruled in limine that there might be any number of reasons why the agency would not take action completely independent of the merits, such as more pressing priorities, or difficulty of proof or lack of personnel.

[13] Under the terms of the preliminary prospectus, all three founders would have sold some of their own stock and thereby realize a total of about $4 million. When the offering was scaled back, that provision was deleted. Only O'Connor ever disposed of any personal holdings and that was a relatively modest gift to his alma mater.

intentional or in reckless disregard of the highly probable consequences.

THEREFORE IT IS ORDERED that defendants' motions for judgment as a matter of law or in the alternative for a new trial are DENIED.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 94-56379, 94-56380 and 94-56381

NOT FOR PUBLICATION

STANLEY KNAPP, on behalf of himself
and all others similarly situated,
Plaintiff-Appellee,

v.

ERNST & WHINNEY,
Defendant-Appellant.

STANLEY KNAPP, on behalf of himself
and all others similarly situated,
Plaintiff-Appellee,

v.

PHILIP J. GOMEZ; DOUGLAS J. O'CONNOR,
Defendants-Appellants.

STANLEY KNAPP, on behalf of himself
and all others similarly situated,
Plaintiff-Appellee,

v.

PHILIP J. GOMEZ; DOUGLAS J. O'CONNOR;
ERNST & WHINNEY,
Defendants-Appellees.

ORDER DENYING REHEARING

[filed Sept. 4, 1996]

Before: WALLACE, FERGUSON, and T.G. NELSON, Circuit Judges.

The petition for rehearing filed by Gomez and O'Connor is denied.

The panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc filed by Ernst & Whinney.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

Ernst & Whinney's petition for rehearing is denied, and the suggestion for rehearing en banc is rejected.

APPENDIX F

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

James HENDRY, an individual doing business as Synergy Sales Engineering,
Plaintiff/Appellee/Cross-Appellant,

v.

EXIDE ELECTRONICS CORPORATION, a North Carolina corporation,
Defendant/Appellant/Cross-Appellee.

Nos. 90-15964, 90-16148.

Argued and Submitted May 12, 1992.
Decided Sept. 8, 1992.
Motion to Recall and Clarify Mandate Granted Jan. 29, and May 27, 1993.

Appeal from the United States District Court for the Northern District of California, No. C-89-0077 SAW; Stanley Weigel, District Judge, Presiding. N.D. Cal.

REVERSED and REMANDED.

Before CHOY, HUG and RYMER, Circuit Judges

MEMORANDUM*

This case involves a dispute between Exide Electronics Corporation ("Exide"), a manufacturer of electrical equipment including uninterruptible power supply ("UPS") systems and James Hendry, its former sales representative doing business as Synergy Sales Engineering ("Hendry" or "Syner-

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

gy"). Exide appeals from a $14.9 million judgment entered on a general verdict for Hendry.[1] Hendry cross-appeals from the district court's denial of his request for attorney's fees on the basis of Exide's alleged bad faith conduct before and during the litigation and requests review of the district court's jury instruction concerning punitive damages. Because we find that the district court erred as a matter of law in instructing the jury that North Carolina law implies a duty of good faith in the termination of an at-will employee and that Exide could not terminate Hendry in bad faith in order to avoid paying him commissions, we reverse.

I. FACTUAL BACKGROUND

Hendry's claims are based on Exide's alleged breach of two contracts, the Power Systems Agreement for Fiscal Year 1987 (the "Rep Agreement") and an oral agreement that Hendry contends he and Exide entered into sometime in late December 1986 or early January 1987.[2]

The written Rep Agreement executed by Exide and Hendry expressly superseded all prior contracts between the parties regarding UPS sales, and authorized Synergy to sell Exide UPS products in Northern California and most of Nevada. Synergy's performance under the contract was to be

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[1] Hendry's second amended complaint alleged: (1) breach of written sales representative contract; (2) breach of an oral agreement; (3) breach of the implied covenant of good faith and fair dealing; (4) fraud; and, (5) services rendered—quantum meruit.

[2] Synergy began acting as Exide's sales representative in 1985, a relationship that continued until Exide terminated Synergy on March 2, 1987. In February 1985 Exide and Hendry entered into a representative agreement for fiscal year 1985 that appears to have contained largely similar provisions to the written agreement at issue in this case. Although that agreement automatically expired on September 30, 1985, thereafter Hendry continued to represent Exide without a written contract in effect until December 1986.

measured according to the volume and mix of products it sold. The Rep Agreement provided that it would expire automatically and without notice after one year, but also provided that either party could terminate the agreement without cause on 120 days notice.[3] The agreement specifically contemplated payment of post-termination commissions. It set out a procedure for calculating those commissions whereby, after Hendry received a termination notice, the parties would negotiate a list of the pending UPS projects that Hendry was soliciting at the time he was terminated ("protect list"). If during the 120-day notification period any of those projects on the protect list resulted in "an acceptable purchase order delivered to Exide," Synergy was entitled to payment of the appropriate commission for that project. *Id.* at ¶ I(9) (the "post-termination compensation provision").

On March 2, 1987 Exide invoked the without cause termination clause and terminated Synergy. The parties subsequently exchanged and negotiated lists of Synergy's pending UPS projects.

In addition, and while the Rep Agreement was still in effect, Hendry claims that he entered into an oral agreement with Philip Tompkins, Exide's Vice President for Domestic Sales. Exide disputes that any oral agreement ever was made. According to Hendry, sometime in late December 1986 Tompkins phoned him. During that call he claims that they agreed that Exide would pay him a reduced 30%

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[3] This section stated that "[t]his Agreement may be terminated without cause prior to the expiration hereof by either party upon 120 days written notice...." Rep Agreement at ¶ I(2). Other provisions relating to termination provided that "[n]o termination shall relieve either party of any obligation it may have to the other party hereto incurred under this agreement prior to the effective date of termination;" *id.* at ¶ I(8), and that "in no event shall the termination notice required to be given be less than the minimum written notice permitted by law." *Id.* at ¶ I(5).

commission on the $1 million UPS contract that Exide was awarded in October 1986 for Warner-Robbins Air Force Base ("Warner-Robbins contract") in exchange for a 100% commission (less destination credit if the shipment was outside Synergy's assigned territory), on all future UPS projects out of McClellan Air Force Base ("McClellan"). They also agreed that Exide would cooperate fully with and support Synergy's representatives at McClellan and that Exide would coordinate a meeting among Exide, Synergy, and McClellan. On January 13, 1987 and February 12, 1987 Hendry wrote and sent two identical letters to Tompkins. Both letters reiterated the terms discussed during the alleged telephone call and contained no additional terms. Exide maintains that no one at Exide wrote back to Hendry or confirmed his understanding as set forth in these letters.

The heart of Hendry's case is that Exide acted in bad faith when it terminated him as its sales representative in order to avoid paying commissions he was entitled to in connection with three UPS contracts: a $621 million five-year Air Force UPS requirements contract that was solicited out of the Air Logistics Center at McClellan (the "ALC contract");[4] the sale of UPS equipment to GTE Government Systems;[5]

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[4] The majority of this appeal (and the case below) focuses on Hendry's entitlement to commissions under the ALC contract and $14.8 of the $14.9 million judgment in the district court awarded as to that contract.

[5] This alleged breach related to GTE's award of a contract for purchase of Exide UPS products to Engineering Data Environments ("EDE"). In March 1986 Hendry began soliciting GTE Government Systems and eventually requested a bid from Exide's domestic sales division with regard to a potential GTE sale. EDE, however, also had solicited a bid on the same project but from Exide's international division (since the GTE purchase was destined for overseas). EDE received a lower quotation, GTE awarded it the contract, and Exide paid EDE the commission. Hendry claimed a

and OEM sales made in Hendry's territory.[6] Exide disputes that it terminated Hendry to deny him commissions and contends that he was terminated because of his poor sales performance in the western region.

II. STANDARD OF REVIEW

The question presented in this appeal involves interpretation of North Carolina law. We review the district court's state law determinations *de novo* and its determinations of the applicable state law are not entitled to any deference. *Salve Regina College v. Russell*, 111 S.Ct. 1217, 1221-25 (1991); *see In re McLinn*, 739 F.2d 1395, 1403 (9th Cir. 1984) (en banc).

III. ANALYSIS

A. General Verdict

Hendry contends that the judgment below must be upheld if it can be supported on any theory properly presented to the jury and argues that, because Exide failed to challenge the fraud verdict and it was properly presented to the jury, under this rule the court should affirm the judgment on the basis of

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right to the commission because he allegedly had an exclusive right to sell in the territory and because Exide's providing EDE with a lower quotation was a breach of the implied covenant of good faith in the Rep Agreement since Hendry had persuaded GTE to specify Exide products, the lower bid violated Exide policy, and because Exide sought to conceal it.

[6] Hendry claimed a right to commissions for all OEM sales made in his territory from February 1985 through July 1987. Exide apparently handled these sales directly but, in order to prevent direct sales rep competition, paid them 20% of normal commissions on OEM sales in their territory. Exide claims that Hendry presented no evidence of any such sales, but only the conclusory testimony of an expert regarding their amount. Hendry argues that the jury award was proper.

that claim. *Kern v. Levolor Lorentzen, Inc.*, 899 F.2d 772, 777 (9th Cir. 1990); *Benigni v. City of Hemet*, 879 F.2d 473, 478 (9th Cir. 1988); *Roberts v. College of The Desert*, 870 F.2d 1411, 1417 (9th Cir. 1988). Exide responds that we must reverse the general verdict if any one theory of liability improperly was presented to the jury and argues that we should not apply the narrow exception articulated in the decisions cited by Hendry in this case.

The general rule in this Circuit is that "a general jury verdict will be upheld only if there is substantial evidence to support each and every theory of liability submitted to the jury." *Kern*, 879 F.2d at 777 (quotation & citations omitted). This rule is in accord with a long line of precedent in which the Supreme Court has held that, when faced with a general verdict where "upon any one issue error was committed, either in the admission of evidence, or in the charge of the court [such a general] verdict cannot be upheld...." *City of Columbia v. Omni Outdoor Advertising, Inc.*, 111 S.Ct. 1344, 1356 (1991); *Sunkist Growers, Inc. v. Winckler & Smith Citrus Prods. Co.*, 370 U.S. 19, 29-30 (1962); *United New York & New Jersey Sandy Hook Pilots Ass'n v. Haleki*, 358 U.S. 613, 619 (1959); *Maryland v. Baldwin*, 112 U.S. 490, 493 (1884).

Despite this general rule, in our discretion, we may "construe a general verdict as attributable to one of several theories if it was supported by substantial evidence and was submitted to the jury free from error." *Kern*, 899 F.2d at 777.[7] In deciding whether it to exercise this discretion,

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[7] Although Exide argues that the Supreme Court's recent affirmation of the general rule in *City of Columbia* calls into question the continued validity of this Circuit's exception to the general rule, we have been aware that this exception is contrary to Supreme Court precedent since well before *City of Columbia*. *Syufy Enterprises v. American Multicinema*, 793 F.2d 990 (9th Cir. 1986), *cert. denied*, 479 U.S. 1034 (1987); *Kern*, 899 F.2d at 777

however, the factors we must consider are: (1) the potential for confusion of the jury that may have resulted from erroneous submission of a particular claim or cause of action; (2) whether the losing party's defenses apply to the count upon which the verdict is being sustained such that they would have been considered by the jury with reference to that count; (3) the strength of the evidence supporting the count being relied on to sustain the verdict; and, (4) the extent to which the same disputed issues of fact apply to the various legal theories. *Traver v. Meshriy*, 627 F.2d 934, 938 (9th Cir. 1980); *Kern*, 899 F.2d at 777.

We balance these factors in an *ad hoc* manner, without any one factor being accorded particular weight and without necessarily considering all four factors in each case. *See, e.g., Benigni*, 879 F.2d at 478 (exercising discretion on basis of strong evidence of two factors); *Syufy*, 793 F.2d at 1002 (reversing and refusing to exercise discretion on poor showing of only two factors).

Hendry urges us to affirm the general verdict under the *Traver* exception arguing that the fraud theory properly was submitted to the jury and that there was substantial evidence to support that theory of liability. We conclude that the *Traver* exception is not applicable in this case and decline to exercise our discretion.

Only two of our opinions have considered the potential for jury confusion as a significant factor in applying the *Traver* factors. In *Syufy Enterprises* we noted that the potential for jury confusion "was great" because the case was complex, involved multiple antitrust theories, and each claim involved distinctive factual and legal components. *Id.* at 1001-02. In *Kern*, although the jury improperly was instructed on an age discrimination claim, we concluded that the jury

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n.2. Despite criticism, we continue to apply the exception. *Id.* at 782, 789-92 (Kozinski, J., dissenting).

was unlikely to be confused because Kern's counsel had stressed the properly presented contract claim in closing argument and the age discrimination claim only presented as a possible ground for the defendant's disparate treatment of Kern and never was offered as an independent ground for recovery. *Kern*, 899 F.2d at 777.

This case, like *Syufy* and *Counts v. Burlington Northern Railroad*, 952 F.2d 1136 (9th Cir. 1991), involved five theories upon which Hendry sought recovery, each involving differing legal components, and many requiring evaluation of distinct factual circumstances. *Id.* at 1140; *Syufy*, 793 F.2d at 1001-02. Moreover, unlike in *Kern*, Hendry's counsel apparently did not even mention the fraud claim in closing arguments and requested a damages calculation under the written contract rather that on the basis of a fraud damages calculation. *Kern*, 899 F.2d at 777. This factor, therefore, weighs against our exercising discretion.

Similarly, the only two opinions in which we applied the second *Traver* factor regarding defenses both involved claims for which the defenses offered were identical. *Traver*, 627 F.2d at 939 (defenses of reasonable conduct and action in good faith apply to the improperly presented section 1983 claim as well as to the properly instructed state tort actions); *Kern*, 899 F.2d at 777 (defense of treatment in accordance with company policy and discharge for legitimate business reason same for both proper contract claim and improper age discrimination claim). In *Kern* we noted that this fact meant that "[t]he jury could not have found in favor of Kern under any of her theories without rejecting these defenses." *Id.*

Conversely, in this case Exide offered different defenses to each theory of liability and thus the jury could have found for Hendry on any one claim without necessarily being compelled to reject a valid defense that was applicable only to that separate claim. Thus, this factor also weighs against exercise of discretion.

Significantly, in every case in which we have applied the *Traver* exception to uphold a general verdict under the final *Traver* factor, the various legal theories at issue involved virtually identical disputed issues of fact.

In *Kern*, under both the age discrimination and the contract claims, Kern urged that, without adequate explanation, he was treated differently from other employees. *Kern*, 899 F.2d at 778. In *Benigni* we stated that, although the fourteenth amendment claim was not supported on the equal protection ground, we nonetheless could uphold the general verdict under the due process theory because both claims involved the same disputed issues of fact "both being grounded on the allegation of arbitrary law enforcement activity for the purpose of harassment and interference." *Benigni*, 879 F.2d at 478; *see also Roberts*, 870 F.2d at 1417. Finally, in *Traver* we noted that the section 1983 claim, which improperly was submitted to the jury, was "all but derivative" of the state tort claims on which we sought to uphold the general verdict. Further, in that case a finding of section 1983 liability "would necessarily encompass a finding of liability on one or more of the state law claims," that were properly before the jury. *Id.* at 939.

In contrast, Hendry's claims involve largely differing disputed issues of fact. The fraud claim, for example, was distinct in its requirement of evidence establishing that Exide was aware that its alleged promises were false. This case is more like Syufy where we held that the *Traver* exception was inapplicable, in part, because "although many of the claims shared common issues of fact each also involved distinctive legal and factual components." *Syufy*, 793 F.2d at 1002.

Finally, with regard to the strength of the evidence supporting the fraud count, under the *Traver* factors we require more than "marginal evidence," *id.*, although precisely what level of proof must be present is unclear. *Kern*, 899 F.2d at 798 (evidence "while not overwhelming, strong"); *Benigni*, 879 F.2d at 478 ("clearly supported");

Traver, 627 F.2d at 939 ("ample evidence"). We need not attempt an evaluation of this factor—an investigation that particularly would be onerous given the parties' disagreement over the facts presented at trial—because all three of the other *Traver* factors clearly weigh against our exercising discretion in this case.

In conclusion, we reject Hendry's request to uphold the general verdict on the basis of the fraud verdict and adhere to the general rule that requires reversal of the district court judgment if any one theory improperly was presented to the jury.

B. North Carolina Does Not Imply a Covenant of Good Faith to Prohibit Termination in Bad Faith of an At-Will Employee

Exide contends that the district court erred when it instructed the jury that Exide was bound by the implied covenant of good faith in terminating Hendry and that if Exide terminated Hendry in bad faith in order to avoid paying him commissions, it would have breached the Rep Agreement.[8] Our review of North Carolina law confirms that the

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[8] The district court instructed the jury with regard to implied good faith as follows:

> If a manufacturer offers to pay a commission to its representative if the representative accomplishes a specified result, the representative is entitled to commission if the manufacturer revokes the offer in order to avoid paying the commission and the result is thereafter accomplished as a proximate result of the representative's efforts.
>
> The Representative Agreement provided that Exide could terminate the contract without cause. Such termination, however, is subject to a legal requirement of good faith. Good faith means an honest intention to abstain from taking any unconscientious advantage of another, even through technicalities of law, together with the absence of all informa-

district court erred in instructing the jury on implied good faith.

In its recent decision in *Amos v. Oakdale Knitting Co.*, 416 S.E.2d 166 (N.C. 1992), the North Carolina Supreme Court made clear that North Carolina would not imply a covenant of good faith to prohibit Exide from terminating Hendry in bad faith. In *Amos* the court clarified the scope of its decision in *Coman v. Thomas Manufacturing Co.*, 381 S.E.2d 445 (N.C. 1989) in which it explicitly had recognized a public policy exception to the employment at-will doctrine and authorized a tort claim for the wrongful discharge of an at-will employee who has been terminated in violation of public policy. *Id.* at 447.[9]

In addition to this holding, the court discussed in dictum the more general question of bad faith discharge. In this regard the court stated that it had "never held that an employee at will could be discharged in bad faith," *id.* at 448 (citing *Haskins v. Royster*, 70 N.C. 601 (1874) & *Malever v.*

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tion, notice, benefit or belief which could render the transaction unconscientious.

Therefore, a manufacturer cannot ignore the efforts of his representative and escape liability for commissions by terminating a representative for the purpose of avoiding such commissions.

Appellant's Excerpts of Record (ER) Tab I, at 4093.

[9] The *Coman* court approved and adopted language from *Sides* v. *Duke University*, 328 S.E.2d 818 (N.C. Ct. App. 1985) and stated that: while there may be a right to terminate a contract at will for no reason, or for an arbitrary or irrational reason there can be no right to terminate such a contract for an unlawful reason or purpose that contravenes public policy. A different interpretation would encourage and sanction lawlessness, which law by its very nature is designed to discourage and prevent. *Coman*, 381 S.E.2d at 447 (citing *Sides*, 328 S.E.2d at 826).

Jewelry Co., 25 S.E.2d 436 (1943)), and that courts in other states "have recognized wrongful discharge theories characterized either as the bad faith exception to the at-will doctrine or under the implied covenant of good faith and fair dealing." *Id.* at 448 (citations omitted). Finally, the court added that "[b]ad faith conduct should not be tolerated in employment relations, just as it is not accepted in other commercial relations." *Id.*

In the aftermath of the *Coman* decision courts interpreting this bad faith dictum split as to its meaning.[10] *Amos*, however, settled any debate as to the scope and meaning of *Coman* by explicitly holding that the *Coman* discussion of bad faith discharge was merely dictum, and that the *Coman* holding only established a limited exception to the employment-at-will doctrine that prohibits the termination of at-will employment contracts for an unlawful reason or a purpose that contravenes public policy, but does not recognize an independent claim for wrongful discharge in bad faith. *Amos*, 416 S.E.2d at 173.

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[10] *Compare Intrube* v. *Wandel & Goltermann Techs.*, 774 F. Supp. 959, 963 (M.D. N.C. 1991) (*Coman* dictum as articulating a bad faith exception to at-will discharge); *Harrison* v. *Edison Bros. Apparel Stores, Inc.*, 924 F.2d 530, 933 (4th Cir. 1991) (same); *Mayse* v. *Protective Agency, Inc.*, 772 F. Supp. 267, 275-76 (W.D. N.C. 1991) (same) *and Salt* v. *Applied Analytical*, 412 S.E.2d 97 (N.C. Ct. App. 1991) (*Coman* did not create an independent tort claim for bad faith discharge), *review denied*, 415 S.E.2d 200 (1992); *English* v. *General Elec. Co.*, 765 F. Supp. 293, 295-96 (E.D. N.C. 1991) (same); *Percell* v. *IBM, Inc.*, 765 F. Supp. 297, 302 (E.D. N.C. 1991) (same); *see also McLaughlin* v. *Barclay's American Corp.*, 382 S.E.2d 836 (N.C. Ct. App.) (*Coman* bad faith discussion not merely dictum established tort for bad faith discharge), *review denied*, 385 S.E.2d 498 (1989); *Riley* v. *Dow Corning Corp.*, 767 F. Supp. 735 (M.D. N.C. 1991) (same).

The Rep Agreement was an at-will employment contract because, although it was not indefinite in duration and was scheduled to expire automatically in one year, during that year either party was free to terminate the agreement "without cause." Thus, given *Amos*, the district court's instruction regarding good faith termination was erroneous.

Hendry, however, urges that the district court's implied good faith instruction was proper under North Carolina's "procuring cause rule."[11] Because the North Carolina Supreme Court's holding in *Amos* did not discuss and apparently left intact this rule, we address whether, despite the *Amos* decision, the district court's good faith instruction nonetheless was proper under this rule.

North Carolina's procuring cause rule implies a good faith obligation in the termination of agency agreements, and specifically in real estate listing agreements. *See, e.g., Realty Agency, Inc. v. Duckworth & Shelton*, 162 S.E.2d 486, 491 (N.C. 1968); *White v. Pleasants*, 36 S.E.2d 227, 229 (N.C. 1945); *Jaudon v. Swink*, 276 S.E.2d 511, 513 (N.C. Ct. App.

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[11] In instructing the jury, Judge Weigel apparently relied on a line of North Carolina cases involving the procuring cause rule as well as on section 454 of the *Restatement (Second) of Agency*. Section 454, entitled "Revocation in Bad Faith of Offer of Compensation," provides that:

> An agent to whom the principal has made a revocable offer of compensation if he accomplishes a specified result is entitled to the promised amount if the principal, in order to avoid payment of it, revokes the offer and thereafter the result is accomplished as the result of the agent's prior efforts.

Restatement (Second) of Agency § 454, at 370. Judge Weigel particularly cited comment a to that section which provides in part that "specific reparation is afforded the agent by disregarding the revocation and determining his right to the promised compensation as though no revocation had been made." *Id.* at comment a.

1981). Courts have construed this good faith obligation as prohibiting a principal from terminating the agency in order to avoid paying the agent a commission. *Jaudon*, 276 S.E.2d at 513 (citing *Cromartie v. Colby*, 108 S.E.2d 228 (N.C. 1959) & *Martin v. Hooy*, 10 S.E. 83, 84 (N.C. 1889).[12]

Notably, however, North Carolina courts impose an important limitation on the operation of the procuring cause rule that specifically excludes from the rule's reach circumstances where the parties involved expressly have contracted out from under the rule. *Id.* at 491; *Brown v. Fulford*, 316 S.E.2d 220, 222 (N.C. 1984); *Castle & Assocs. v. Custom Molders, Inc.*, 311 S.E.2d 640, 641 (N.C. Ct. App. 1984); *Cooper v. Henderson*, 284 S.E.2d 756, 758 (N.C. Ct. App. 1981); *accord Masajarian v. Mark Lighting Fixtures Co.*, 595 F. Supp. 869, 872 (D. Conn. 1984); *Ullmann v. May*, 72 N.E.2d 63, 67-68 (Ohio S. Ct. 1947); *Willis v. Champlain Cable Corp.*, 748 P.2d 621, 627-28 (Wash. 1988); *see also Balzer/Wolf Assocs. v. Parlex Corp.*, 753 F.2d 771, 774-75 (9th Cir. 1985). Thus, when stated its entirety, the procuring cause rule provides that "[i]f any act of the broker in pursuance of his authority to find a purchaser is the initiating act which is the procuring cause of a sale ultimately made by the owner, the owner must pay the commission, provided the case is not taken out of the rule by the contract of employment." *Realty Agency*, 126 S.E.2d at 491 (emphasis added).[13]

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[12] An agent is the "procuring cause" where he is "a cause originating or setting in motion a series of events which, without break in their continuity, result in the accomplishment of the prime objective ... the procurement of a purchaser who is ready, willing, and able to buy on the principal's terms." *Realty Agency*, 162 S.E.2d at 489.

[13] We disagree with the dissent for a number of reasons. First, our reading of the procuring cause rule is that it only implies a

requirement of good faith in termination if the parties' contract fails to specify when the agent is entitled to receive commissions. In the absence of such a provision, the rule attributes the employer a duty of good faith in terminating the agent. Significantly, when the duty of good faith is implied, it is only implied to the limited extent that it supplies the missing contractual term regarding when the agent is authorized to receive commissions thus requiring the employer to pay him commissions on projects for which he was the "procuring cause." If the parties do contract regarding commissions, the rule simply does not apply.

Second, we disagree that, because Hendry was a commissioned sales agent rather than an employee earning an hourly wage, the procuring cause cases rather than *Amos* and those decisions regarding discharge of at-will employees, are more pertinent to this case. As a general matter, we believe that courts, if anything, would be more solicitous of protecting at-will employees from bad faith discharge than they would be inclined to shield agents or independent contractors from such conduct. *See* Henry H. Perritt, Jr., *Employee Dismissal Law and Practice* § 7.2, at 63-64 (3d ed. 1992). Thus, we doubt that the North Carolina Supreme Court would extend protection against bad faith terminations to agents or independent contractors by way of the procuring cause rule when in *Amos* that same court declined to imply a covenant prohibiting bad faith terminations of employees.

Finally, even assuming arguendo that the procuring cause rule applies to a termination scheme like that alleged in this case, the fact remains that Judge Weigel's instruction regarding good faith did not properly state the rule. The instruction regarding the procuring cause rule and good faith in termination, which indeed mimics the language of *Jaudon* v. *Swink*, 276 S.E.2d 511, 512-13 (N.C. Ct. App. 1981), failed to include the part of that rule which states that the parties may contract out of that rule. Therefore, even if the procuring cause rule applied to the circumstances of this case and acknowledging that the good faith issue was for the jury to decide, there remains a question whether the jury properly had been instructed that the parties could "contract out" of the procuring

The Rep Agreement provided that:

> [a]t the time of termination, a list of pending orders will be received by the parties and appropriate compensation will be due on all such quotations which resulting an acceptable purchase order delivered to Exide Electronics within the required notification period. An acceptable order shall be an order which satisfies all requirements as set forth in the Exide Electronics Sales Manual current at the time of submission of order.

Rep Agreement at ¶ I(9). This post-termination compensation provision unambiguously establishes that Hendry was entitled to receive commissions only on those projects identified on his protect list at the time he received notice of termination and that resulted in "acceptable purchase orders" within the 120-day notification period. Moreover, there are no other provisions in the Rep Agreement that create any ambiguity or that call into question the obvious reading of this provision. *St. Yves v. Mid State Bank*, 757 P.2d 1384, 1386-87 (Wash. 1988) (en banc). *But see Caton v. Leach Corp.*, 896 F.2d 939, 944 (5th Cir. 1990).[14]

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cause rule—might it have concluded that Hendry and Exide had done so and that the procuring cause rule, in fact, did not preclude Hendry's termination in bad faith?

[14] The *Caton* court, interpreting a representative agreement under tenants of California contract law comparable to those employed by North Carolina courts, found the contract ambiguous because, although the provision regarding post-termination commission on orders "accepted" before termination was not ambiguous a separate provision of the contract suggested, contrary to the plain meaning of the post-termination provision, that the representative was to acquire rights to an allocated portion of commissions upon his mere performance of certain duties. *Id.*

The post-termination compensation provision illustrates that Hendry and Exide contracted out from under the procuring cause rule and that they did not intend Hendry to receive commissions solely as a result of his role in soliciting or procuring UPS contracts. Rather, they contemplated that Exide's receipt of acceptable purchase orders would trigger Hendry's entitlement and that absent this, Hendry would not receive commissions.[15]

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[15] Hendry urges that, within the context of large-scale military procurements, the Air Force's formal ALC solicitation (issued on March 12, 1987) was the equivalent of an acceptable "purchase order" delivered within the Rep Agreement's 120-day notice period and that Exide, by submitting a bid in response to that solicitation, "accepted" the order. This argument is without merit because the solicitation cannot reasonably be construed as a "purchase order."

The Air Force solicitation, on its face, was an invitation to submit offers to the Air Force for a five year requirements project and, as such, it directed that "[a]ll responsible sources may submit an offer which shall be considered." Only a strained and unreasonable reading possibly could find that the language of this one paragraph document constituted a $621 million purchase order directed to Exide. Nor was the ALC contract an "acceptable purchase order." Once consummated that contract merely provided that, if and when the Air Force required UPS products, it was required to order them from Exide and that Exide must offer them for sale at the prices in the ALC contract as agreed upon by the parties and did not constitute an actual order for any particular UPS products.

The best evidence that the ALC solicitation was not a "purchase order," however, is the plain language of another document involved in the ALC contract, entitled an "Order for Supplies and Services." As Hendry himself admits, after the ALC contract was executed it fully was automated in that no further Exide sales effort or negotiation was required. The Air Force would simply submit an "Order for Supplies and Services" to Exide and Exide would then fill the order and be paid the price provided in the contract.

We conclude that the district court erred in instructing the jury that Exide had an implied duty of good faith in terminating Hendry because the North Carolina Supreme Court's recent decision in *Amos* makes clear that North Carolina does not recognize a separate claim for wrongful discharge in bad faith, and because the procuring cause rule does not apply on these facts since the Rep Agreement contains an express provision regarding post-termination commissions and Exide and Hendry therefore contracted out from under that rule.

REVERSED and REMANDED to the district court which shall order retrial of such of the claims for relief other than covered by our decision, which the district court determines are still viable.

HUG, Circuit Judge, dissenting.

I respectfully dissent because I conclude that the district court's implied good faith instruction was proper under North Carolina's "procuring cause rule." As the majority notes, the North Carolina Supreme Court's holding in the recent case of *Amos v. Oakdale Knitting Co.*, No. 278A92, 1992 WL 96892 (S.Ct. N.C. May 8, 1992), left intact the procuring cause line of authority. The majority correctly states the controlling principles of this line of authority. "North Carolina's procuring cause rule implies a good faith obligation in the termination of agency agreements, specifically in real estate listing agreements. . . . Courts have construed this good faith obligation as prohibiting a principal from terminating the

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What Hendry neglected to note is that the "Order for Supplies or Services" form, despite its title, clearly pronounces itself to be a "purchase order." This fact is evidenced by the language set out at the middle portion of that document which reads: "ACCEPTANCE: The contractor [Exide] hereby accepts the offer represented by the [illegible word] ... purchase order as it may previously have been or is now modified. Subject to all the terms and conditions set forth and agrees to perform the same."

agency in order to avoid paying the agent a commission." (Majority Opinion p. 15).

The *Amos* case deals with the termination of at-will employees who were being paid hourly wages. There is no issue in this type of case of the amount of compensation due for services rendered—instead, the issue is the duration of continued employment. In the "procuring cause" cases, the issue is whether the principal is terminating an agency agreement in bad faith to deprive the agent of his fair commission. That is the issue faced in this case. Hendry was a sales agent, not an employee earning wages, and the issue is whether Exide, in bad faith, maneuvered the termination of the agency agreement and ultimate sales Hendry procured so as to deprive Hendry of his commission. The district court instructed the jury in virtually the exact words of the North Carolina decision in *Jaudon v. Swink*, 276 S.E.2d 511 (N.C. Ct. App. 1981), which was applying prior North Carolina Supreme Court authority on procuring cause.

The majority, however, believes this was error because the parties had expressly contracted out from under the rule. The contract did provide for commissions to be paid on all acceptable purchase orders received within 120 days of termination. This, however, does not contract out from under the rule. It merely advances by 120 days the maneuvering time for Exide to delay sales that Hendry had procured. Whether Exide did so was a question of fact properly submitted to the jury.